INCREASING CHANCE OF SUCCESS BASED ON ELECTION-YEAR CYCLE

By James B. Cloonan

Historical returns indicate you can increase the chance of investment success if you follow a strategy in which you purchase stocks during the third year of the election cycle if the market is below its high.

Exactly four years ago, my Matter of Opinion article was titled "A Modest Timing Possibility Based on the Business Cycle." Basically, the article demonstrated the relative strength of the stock market in the third year of the election cycle. It also pointed out the greater likelihood of a market rise when the stock market (S&P 500) was 5% or more below its previous high for the year.

When both of these occur at the same time—the third year of the election cycle and a market at the beginning of the year that is 5% or more below the previous high, as it was four years ago in 1995—the likelihood of a strong market is greatly increased.

Well, as they say, it looks like déjà vu all over again! Of course, the S&P 500 is quite a bit higher than four years ago—at 970 today, compared to 450 in my earlier article. Nonetheless, as of this writing, it looks highly likely that by the beginning of 1999 (the beginning of the third year of the election cycle), the S&P 500 will be 5% or more below its previous high of 1190 (this would put it below 1131, which is 95% of the 1190 high).

EXAMINING THE DATA

Table 1 illustrates the election cycle phenomenon. The 23.3% average return for the third year of the election cycle is over twice the 11.3% return of the S&P 500 for all other years since World War II (the last 50 years). Even for as long as our stock market return records go back (1926), the third year of the election cycle has outperformed other years, 19.7% to 8.1%.

But coupled with the historical performance of the third-year phenomenon, there is a second factor: The probability of negative returns occurring in the short run. The time it takes to regain profitability after any down market decreases when an investor buys at a market level that is below the previous high. For example, years in which the market starts out at 5% or more below a previous high have higher returns than other years, although there are exceptions (1974 and the 1930s).

If these two factors are combined into a purchase rule—buy the third year of the election cycle but only when the market is below its high—then the chance of investment success is increased considerably. For example, in the table January 1 of the years 1995, 1991, 1979, 1975, 1971, 1967, and 1963 represented times when the market was 5% or more below the previous high. The average return for those years is 26.4%.

Given where the market is right now, it seems likely that the S&P 500 will begin next year below its previous high of 1190, although the third-year phenomenon is very strong even without this extra inducement. And because the January effect has been slipping into December, I would take advantage of the third-year election cycle by switching additional funds into common stocks in early December, exactly as I suggested in my column four years ago this month.

By the way, all of my discussion has been about the general market. Individual stocks will reflect these phenomena only to the extent they are corre-

James B. Cloonan is chairman of AAII.

TABLE 1. RETURNS IN 3RD YEAR OF ELECTION CYCLE FOR

Year	Return (%)	January 1 5% or more below prior high
1995	37.6	Yes
1991	30.5	Yes
1987	5.2	
1983	22.5	
1979	18.4	Yes
1975	37.2	Yes
1971	14.3	Yes
1967	24.0	Yes
1963	22.8	Yes
1959	12.0	
1955	31.6	
1951	24.0	
Average	**23.3**	**26.4**

lated to the market.

INTERMEDIATE SWINGS

I have always talked about a long-term portfolio, and resisted trying to time the market in the short term. I have not been opposed to intermediate market timing based on the business cycle, but have felt it should be done with only a portion of a portfolio. For example, if the long-term average asset allocation suitable for you was 60% equities, then based on economic conditions in the intermediate term, it could vary from 45% to 75%.

This variation over time is not intended as much to choose market ups and downs, as it is to take advantage of the fact that stocks are less risky at some times. This same approach could be taken with bonds—reduce holdings when interest rates are lower.

In fact, with Treasury yields under 5%, one might conclude that any shifting into stocks might well come from long-term debt. Even intermediate-term adjustments demand a proven and consistent approach and are suitable only for investors who are willing to spend more time examining various economic cycles. ✦