White Paper

Investing in a highly politicized climate

Tune out political noise and focus on the fundamentals—the real driver of investment returns.

Key highlights

- Strong political views can influence your investment decisions.
- Election outcomes have a negligible effect on investment performance.
- Fundamentals have historically had a greater impact on stock market returns.

Investors contend with different emotional influences as they try to manage their portfolios and seek their long-term goals. One of the strongest influences – and potentially, most problematic – is politics.

An investor's political leanings can distort their perception of risk and reward in the decisions they make. Not all investors are politically inclined, but those who are may see the markets as less risky and more attractive when their preferred party is in power. In contrast, those whose party is out of power are likely to feel more pessimistic and see greater risk in the markets.

In this age of information abundance, can investors use the news for their benefit? Mostly no. Instead, tune out the noise if you're looking for prudent guidance and actionable insights on the financial markets. Also, pay attention to the fundamentals, which have a bigger influence on market value than the fickle winds of the political climate.

> **Markets can turn volatile as investors shift their sentiments to align with their political inclinations. But like most external forces, these fluctuations have little long-term impact on the financial markets**

Mark Twain once said,

“Never talk about politics or religion in polite company.”

He could have added money to that list as well.

A combustible mix

People tend to have strong feelings about both politics and money. In many cases, these feelings are closely tied to their backgrounds and personalities. There’s nothing inherently wrong if someone holds strong political beliefs, but it’s important to recognize the influence strong political views can have on different decisions we make, including how we invest money for the future.

This is a critical topic for financial advisors and investors to discuss because political tribalism seems to be at a high point right now. Our country has been through highly politicized periods before, but many of today’s investors may not have lived during those times or may not realize how strong the pull of political tribalism can be.

WHAT IS POLITICAL TRIBALISM?

People with strong political beliefs may self-segregate into tribes of like-minded individuals. Often, they develop a close identification and loyalty to the tribe. This can occur whether the preferred political party of the tribe is in or out of power.

Within tribes, trust is often given to information sources that reinforce existing political beliefs. Views from outside the tribes are usually rejected or ignored. Even established or well-regarded facts are judged for inherent biases. This contributes to confirmation bias among individuals that can affect decisions they make, including those related to money and investing.

IS TRIBALISM STRONGER NOW?

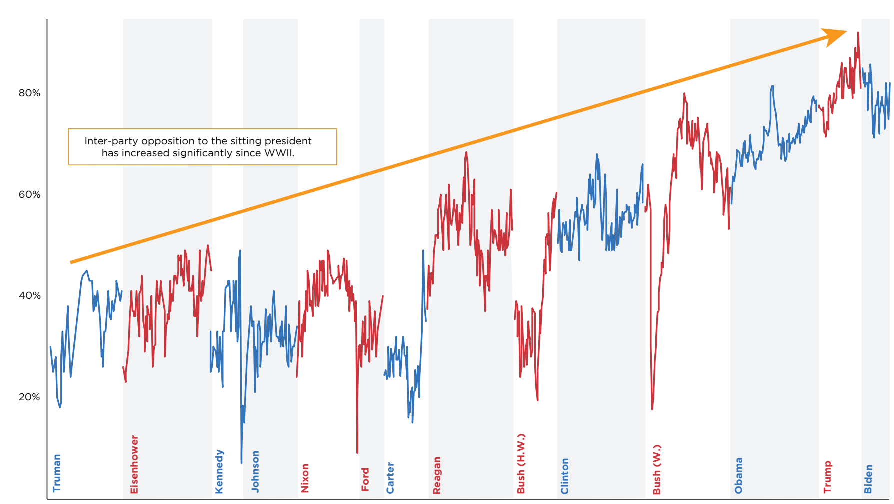
It’s hard to pinpoint the reasons why the gap between the two political parties has widened during this time, but several trends have occurred along with this rise in partisanship.

For one, the media landscape has become more fragmented in recent decades, coinciding with the proliferation of digital media through different channels including streaming video, podcasting and social media feeds. It’s easier than ever for political partisans to tune into organizations and personalities that speak to like-minded views and confirm pre-existing biases.

Two, trust in a wide range of traditional institutions has declined over this time, including the government, the media, the business community and higher education. In the past, the American public viewed these institutions as sources of expertise and authority. The erosion of trust has downgraded the value of expertise and increased awareness of institutional bias.

Presidential approval rating; Spread between president’s party and opposition party

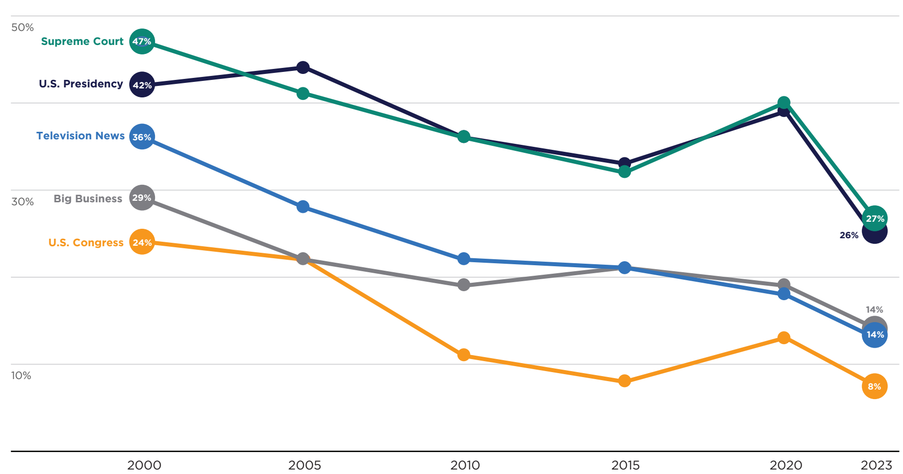
Monthly average of Gallup data — Democratic president — Republican president



Source for chart: Strategas Research

Confidence in American institutions

% of U.S. citizen survey respondents who have “great deal” or “quite a lot” of trust

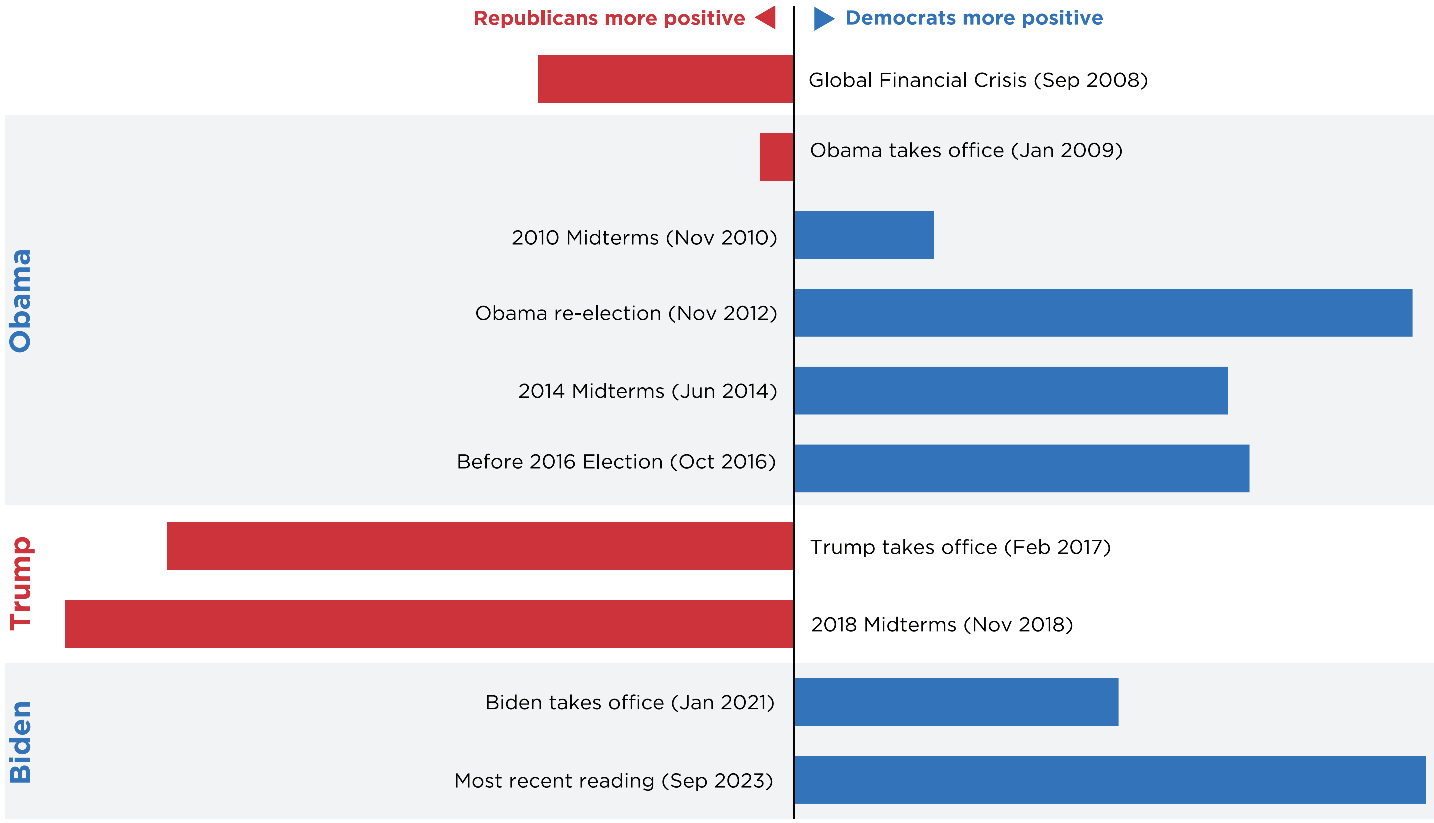


Source for chart data: Gallup “Confidence in Institutions” survey, July 2023

TRIBALISM EMERGES FOR ELECTIONS

Federal election years, especially when control of the White House is at stake, tends to enflame political tribalism. In recent election cycles, shifts in sentiment and confidence between Democrats and Republicans have been astounding and consistent, in particular when control of the executive branch switches parties. Consider the shifts that have occurred after the most recent presidential election cycles. The chart below depicts the partisan gap in consumer sentiment as measured by the University of Michigan Consumer Sentiment Survey in presidential and midterm election years. After 2009, in the post-Global Financial Crisis era when Barack Obama took office, the swings in partisan consumer sentiment grew pronounced.

Partisan swings in consumer sentiment around federal elections
University of Michigan Index of Consumer Sentiment



Source for chart data: University of Michigan, Index of Consumer Sentiment

During the Obama administration, Democrats were broadly satisfied about the state of the economy, while Republicans were largely dissatisfied. These sentiments shifted almost immediately after Donald Trump's election victory in 2016; optimism surged among Republicans and Democrats became widely pessimistic.

A similar shift occurred after Joe Biden won the 2020 presidential election--Democrats were as optimistic among the economy as Republicans were despondent. In both cases, nothing else had essentially changed except control of the Executive Branch. In the most recent reading of this indicator (September 2023), consumer sentiment remained strong among Democrats, but has dropped to multi-year lows among Republicans.

Investing under the influence

The absence of diverse or challenging viewpoints can have an undue influence on investors who live inside these ideological bubbles. Loyalty to the "tribe" can distort their judgment and lead to emotional decisions that run counter to their personal investment objectives.

A research paper[1] on the role of politics in investment decisions found that politically minded investors tend to be more optimistic about market opportunities when their preferred party is in power. As a result, they may take on more risk than they should and expose themselves to potential losses if the market falls.

Conversely, investors whose political party is out of power exhibit greater pessimism about the future. As a consequence, they may pull assets away from the market to lower their exposure to risk. But the greater risk these investors face is missing out on market gains.

Investors under the sway of political tribalism may see a connection between politics and investment that, in reality, does not exist. Market history shows stock returns have been good under Democratic and Republican presidents.

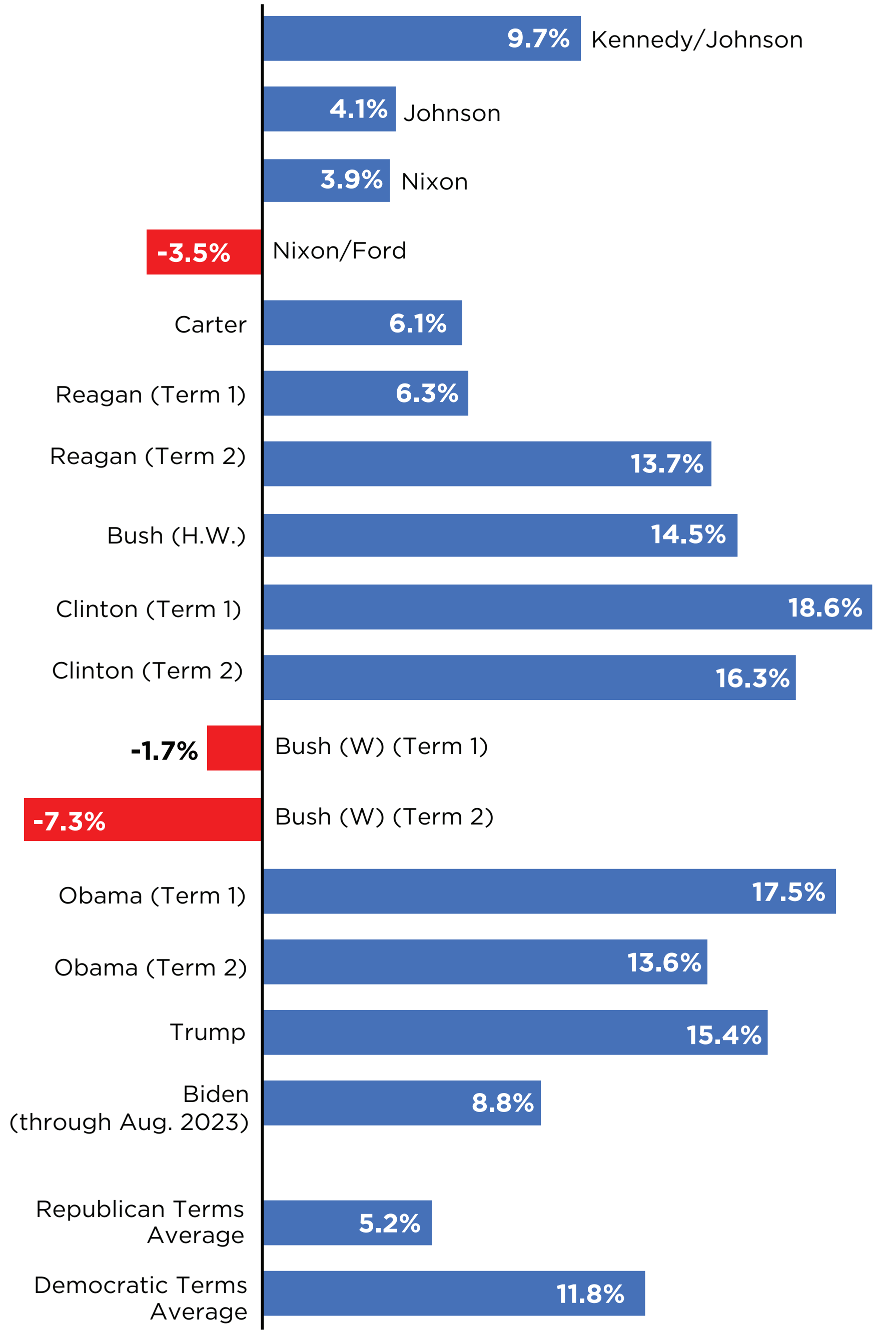
When political partisanship leads investors to connect electoral victories with market performance, confirmation bias is in full effect. For these investors, it can be affirming to believe their deeply held political views translate to financial gain. And politicians may try to link their policies with economic and financial success—it makes for rousing speeches, but doesn't do so much for achieving favorable investment outcomes.

The fact remains, government policy or political control of a particular branch of government has a negligible impact on the direction of the financial markets. What drives market performance most of all is economic and business fundamentals.

[1] Bonaparte, Yosef and Kumar, Alok and Page, Jeremy K., Political Climate, Optimism, and Investment Decisions (February 26, 2012). AFA 2012 Chicago Meetings Paper.

S&P 500 Index annualized return by presidential term

Four-year annualized total return, 1960 to August 2023



Source for chart data: Bloomberg, Plancorp

Focus on the fundamentals

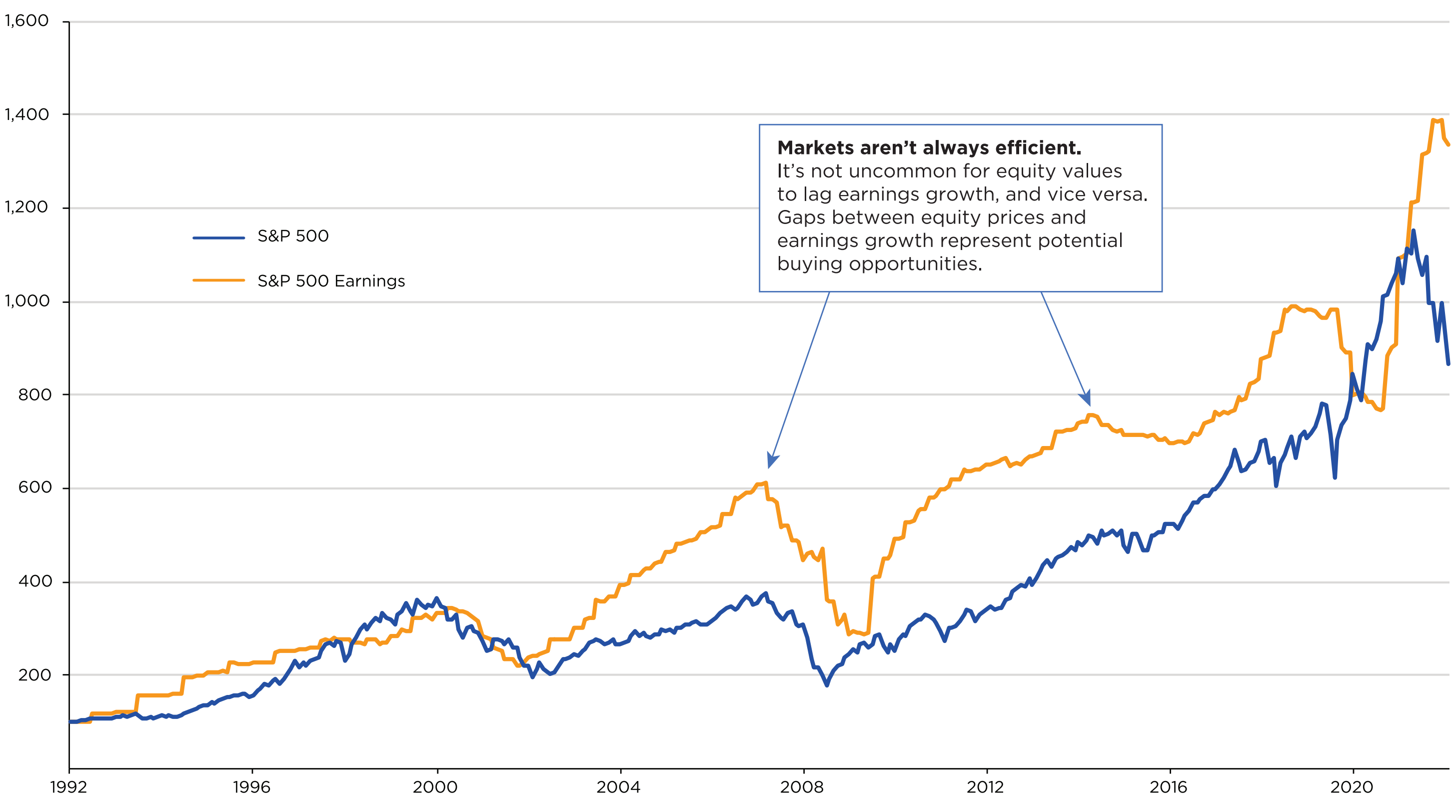
When investment firms talk about “fundamentals,” they’re referring to the results achieved by businesses and the overall economy. This is the hard data such as statistics or similar information that can be measured and compared so investors can judge the potential of a particular investment opportunity.

Fundamentals can include (but aren’t limited to) sales, revenue, cash flows and debt ratios. Perhaps the most important business fundamental to consider is earnings, because company earnings are the primary driver of equity market returns. When a firm can grow earnings, share profits with investors and re-invest in their business, the value of its equity shares tends to increase.

Moreover, companies that deliver consistent earnings growth offer the best potential for long-term appreciation of their equity shares. You can see the link between earnings and equity growth in the long-term trends of both illustrated in the chart below. Over time the annualized growth rate for S&P 500® Index company earnings and the price index are just about equal.

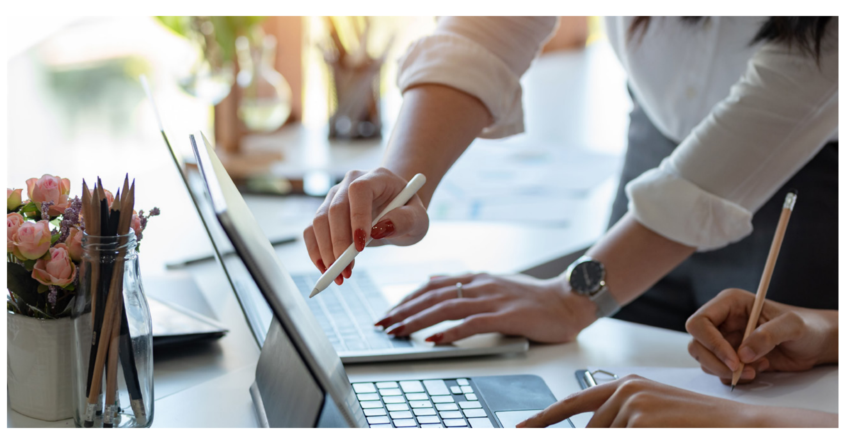
The chart also shows equity returns and earnings growth don’t always move in sync. When gaps appear between equity prices and earnings, it reveals a market that’s not fully efficient. In many cases, these periods of short-term equity volatility are event-driven — investors reacting emotionally to news headlines.

S&P 500 Index vs. earnings growth of S&P 500 companies
August 1992 to September 2023, indexed to 100



Source for chart data: FactSet Research

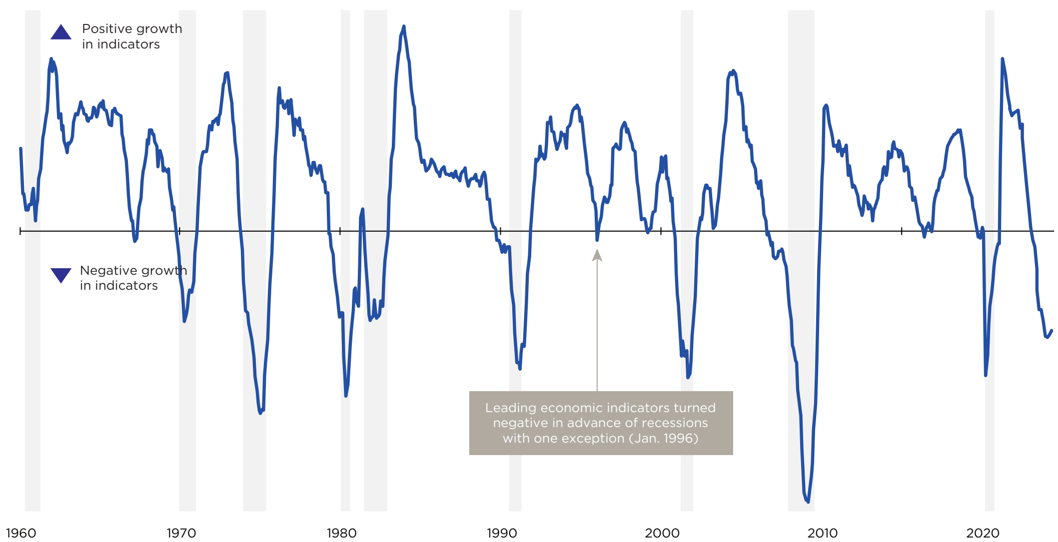
Investors can watch certain indicators for shifts in market or economic trends and prepare for the likelihood of a change in the cycle. For instance, the Index of Leading Economic Indicators (LEI) comprises several fundamental indicators (i.e., employment, wages, factory orders, building permits, etc.) that offers a one-look summary of economic performance. These indicators are important drivers of company performance—when these indicators show strength, the environment is likely to be favorable for corporate earnings, which are the primary drivers of stock market returns.



Similarly, when these leading economic indicators are declining, it may show potential for worsening business conditions, and therefore a tougher climate for stock market returns. In the past, when changes in the LEI Index have turned negative on a year-over-year basis, a recession has occurred in the majority of instances. (The only exception in this trend occurred during the long expansion of the 1990s.)

As the chart to the right shows, the LEI turned negative at the outset of the COVID-19 pandemic. This corresponded to the end of the previous phase of expansion. Investors should pay attention to this index for signs of change in the economic cycle.

Index of Leading Economic Indicators
Year-over-year growth, 1960 to July 2023



Source for chart data: FactSet Research, The Conference Board

Be a savvy investor during election seasons

It's not unreasonable to say investors have too much information at their fingertips these days. While some is valuable, a great deal of it is designed to provoke emotional reactions, especially for people with strong political inclinations.

Investors must rely on their own judgment to extract valuable insights from the information glut. That requires some degree of trust in providers of information, such as news outlets, market analysts and research firms. A healthy amount of self-awareness is also necessary to recognize internal biases and to challenge existing beliefs.

Tips to help temper the influence of political bias in investment decisions:

1

Be conscious of shifts in emotions after election results are announced and check your behavioral biases when making investment or financial decisions.

2

Apply a strong filter to election news coverage to maintain an objective understanding of the events shaping our world.

3

Remember that election results in either party's favor have historically had little impact on future investment returns.

4

Stay focused on the fundamental drivers of investment performance (e.g., company earnings, revenue growth, profit margins, etc.) and leading indicators of economic conditions.

Help your investors know when to tune out the "noise" of political headlines and tune in to their long-term financial goals. Turn to Nationwide for timely insights on the markets and economy that can help your clients make informed investing decisions. **Visit Blog.nationwidefinancial.com**

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S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

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