

INSIGHT & OUTLOOK

A QUARTERLY MARKET COMMENTARY & NEWSLETTER PUBLISHED BY PATTON ALBERTSON & MILLER, LLC

Volume 2 Issue 3

September 30, 2004

Presidential Elections & The Market

Bush or Kerry? Does it matter to investors who wins the White House this November? In this issue we'll consider three questions:

- 1) Does the stock market do better under a Republican or a Democrat administration?
- 2) Is there a "Presidential Cycle" that investors can exploit?
- 3) Does the stock market's performance have any predictive value in an election year?

Republican or Democrat?

Conventional wisdom says the stock market does better under a Republican administration. After all, isn't the GOP more pro-business, favoring lower tax rates on income and capital, limited regulation, and free trade? Like so many market beliefs, this one doesn't hold up to close scrutiny.

In the prestigious *Journal of Finance* (Oct. 2003) two UCLA finance professors reported their analysis of 72 years of data. Over the period 1927-1999 stock investors earned on average **9%** more annually when a Democrat was president. The professors used the equivalent of the S&P 500 index and compared its annual total returns to those of 3 month Treasury Bills. This gave them the "excess return" over risk free T-bills and automatically adjusted for high or low inflation rates.

Inside this Issue:

Staying Rich - Page 3
Tax Matters - Page 4

The professors were perplexed by the results. One possible explanation was that investors' expectations were exceeded by the economic decisions made by Democratic administrations. The article noted "It thus seems that the difference in realized returns can be attributed to the market being systematically positively surprised by Democratic policies". In other words investors expected worse policies than they actually got. The professors did not examine to what extent divided government had an impact on market returns.

We looked at the Dow Jones Industrial Average's price returns since the first Eisenhower Administration and found some comfort for Republican partisans. Over that time span (1953-3Q 2004) the average annual return for Republican Administrations was 7.7% compared to 10.4% for Democratic ones, a difference of 2.7%. So perhaps the upcoming election won't have quite the impact on investors' pocketbooks as the professors' longer term study suggested.

"OUR ELECTIONS ARE FREE—IT'S IN THE RESULTS WHERE WE EVENTUALLY PAY."

BILL STERN
SPORTSCASTER & JOURNALIST

Presidential Elections and The Market (continued)

A Presidential Cycle?

Many financial historians have noted a four year cycle in the major stock indices. For example, the DJIA recorded significant lows in 1966, 1970, 1974, 1978, 1982, 1990, 1994, 1998, and 2002. The years 1970, 1974, 1982, and 1990, in hindsight, were major lows that represented excellent buying opportunities. But none of these years were Presidential election years, so what does the Presidential Cycle refer to?

Well, each year of a presidential term seems to have a distinctive personality. Consider the following DJIA data covering the period from 1925 to 2003.

Presidential Term Year	Year 1	Year 2	Year 3	Year 4
Avg DJIA Returns	5.5%	3.8%	14.0%	7.7%
% Up Years	50	60	90	68

Note: Average return for all years was 7.8%

The final two years of an administration, going all the way back to Calvin Coolidge, average much higher returns and a much higher likelihood of “up” years than the first two. Is it just a coincidence? Probably not. Some analysts suggest that presidents make the tough economic decisions at the beginning of their administrations to get the “bad stuff” out of the way before the mid-term elections. That’s why the first two years’ returns are well below the 7.8% historical average and why the first year is often a down year. Of course, 2005 will be the first year of the new Presidential cycle.

During Bush’s first two years the market followed the Presidential Cycle’s pattern to a fault. In the aftermath of the great stock market bubble, the DJIA **fell** 7.1% in 2001 and 16.8% in 2002. This was much worse than the average 4 to 5% gain typically seen. 2003, however, was a very strong year, up 18.1% versus 14% historically. But so far 2004 is not playing out according to the averages. Through September 30 the Dow was down 3.6% for the year. There are still a few weeks left for it to recapture positive ground, but its current status does not bode well for the President as we will see in the next section.

Ballots Follow the Bucks?

Election years, of course, are the fourth years of presidential terms which we noted tend to be positive over two-thirds of the time. Since 1928 the U.S. has held nineteen presidential elections and the incumbent party has won eleven (58%) of them. When the stock market was up through October 31, the incumbent party won 8 of 12 elections. When it was down, the incumbent party lost the White House 4 out of 7 times. Here’s the breakdown:

Election Year 10 Month DJIA Returns		
	Positive	Negative
Incumbent Won	8	3
Incumbent Lost	4	4
% Won	67%	43%

Presidents obviously prefer to see a strong stock market during an election year! Should Bush be worried? The last president to win despite a negative market was Ronald Reagan in 1984. He won an overwhelming landslide against Mondale. Eisenhower won a second term in 1956 (also a landslide) even with the Dow down 1.8%. The champion for overcoming stock market adversity was FDR in 1940. The market, shaken by the fall of France to the Nazis that summer, was down 10.3% but the president beat Wendell Wilkie handily. All three of these winners were running for a second term—the big difference in 2004 is that the nation is at war. Perhaps Bush will take some encouragement from the fact that no Republican war president has ever lost reelection.

Bill Miller

How to Stay Rich¹

By Maria Elena Lagomasino, CEO JPMorgan Private Bank

It's difficult to make The Forbes 400 list, more so to remain on it. Why do some families manage to sustain great wealth while others fail? Only 50 names have endured since the 1982 unveiling of The Forbes 400. That means the odds of sustaining relative wealth, across a span as short as a single generation, are a mere 13%.

While 145 names lost their perch for expected reasons like death or the deliberate dispersion of wealth, 205 on that first list can't be found on today's because their wealth fell short. Fortunes either crumbled in business reversals or just didn't keep pace with the post-1982 boom in asset prices. The biggest land mine to avoid in staying rich that we see in our research is over concentration in a particular investment. People typically create fortunes by single-mindedly pursuing a dream. Yet the concentrated risk that leads to vast riches is often the very risk that destroys wealth. This cycle repeated itself among the 205, as highly concentrated positions in oil, real estate and single stocks knocked name after name off the list.

When the first list appeared, the late-1970s spike in energy prices was still showering wealth on Texas. By 1985 oil well owners were hurting. That year FORBES dropped nine oilmen, among them Ken and Cullen Davis. In 1999 FORBES noted the departure of four du Pont relatives. "Fifteen years ago," FORBES said, "the du Pont family represented 5% of the list. This year, there are none."

But note that the minimum in 1982 was \$90 million. A family that cashed out of a single position worth \$100 million that year and bought the S&P 500 would easily have crossed the \$750 million minimum for 2004 (allowing for some income taxes but no estate tax). Diversification is the key to survival. A single stock position has a less than 50% probability of sustaining wealth over 20 years. But a diversified portfolio increases the probability to 85%.

Diversification, of course, may not always be an option. And selling an asset with strong emotional connections may turn into a wrenching decision for either the founder of a fortune or his heirs.

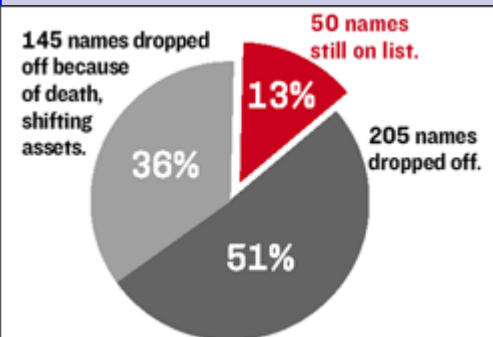
Leverage is another risk. Debt, with a single stock as collateral, can be deadly. If the stock price falls by half, then, even if it eventually rebounds to its original price, the leveraged holder can easily see his wealth shrink by two-thirds in margin calls. In 1990 FORBES took Donald Trump off the list, estimating his net worth at -\$900 million because of over leverage. Trump returned in 1996 when New York real estate rallied. If it hadn't, his comeback may have been questionable.

No investment strategy will bail you out if you spend too much. Prudent spending levels often take wealthy families by surprise. Regardless of asset allocation, spending beyond 3% or 4% of principal is likely to lead, sooner or later, to disaster. If you spend 7% of your wealth annually, you could be facing an 80% likelihood that your purchasing power will drop 20% within 20 years.

One more risk is the risk of being too conservative. Anybody who has covered over a pile of Treasury bills over the past 22 years has seen 44% of his real wealth evaporate in inflation and income taxes. The founding members who survived compounded their wealth (in nominal terms) at an annual 12%, less than the S&P's 13.5% return. Sustaining wealth against the ravages of time and chance is not a small challenge.

The Ravages of Time

The fate of the original Forbes 400: 50 remain on the 2004 list, while 205 dropped off because wealth did not grow enough or it eroded.



Source: JPMorgan Private Bank, with data from Forbes 400 annual editions from Sept. 13, 1982 to Oct. 11, 2004.

¹Reprinted by Permission of Forbes Magazine © 2004 Forbes Inc.



478 Poplar Street
Macon, GA 31201
Phone: 478-742-5554
Fax: 478-742-5542
Email: jimmy@pattonalbertsonmiller.com

WE'RE ON THE WEB:

WWW.PAMWEALTH.COM

Insight & Outlook is published quarterly by Patton Albertson & Miller, LLC. *The statements expressed in this newsletter are the opinions of Patton Albertson & Miller, LLC and do not represent specific investment recommendations or results.*

Tax Matters

During the second week of October, 2004 Congress passed the long anticipated Corporate Tax Bill. While most of the press on this bill talks about tax deductions and tax cuts for businesses, there are some tax increases in the bill of which you should be aware. Here is a brief recap of four selected changes. This list is not exhaustive and, of course, we recommend you contact your accountant for advice relating to your specific situation.

- The tax break for SUV's is being trimmed back from \$102,000 to \$25,000 for vehicles with loaded ratings between 6,000 and 14,000 pounds. The change becomes effective when the President signs the bill and we expect that to happen very quickly since there is an election in 20 short days!
- Deductions for vehicles donated to charity is being reduced. The deduction for donations made after December 31, 2004 will be limited to the amount for which the charity sold the vehicle. The charity will be required to notify the donor and the IRS of the selling price..
- Corporate write-offs for personal use of company planes is being significantly reduced. This will apply to personal use by officers, directors and owners of 10% or more of the company. The company's deduction for operating costs will be limited to the amount of income taxed to the individuals. This will become effective for any personal trips taken after the President signs the bill. Oh, and by the way, this same rule will apply to personal use of company owned vacation homes.
- Home-sale exclusions - if your main residence was purchased using a like kind swap and you sell the home within five years, then no exclusion will be permitted. In other words, you will owe tax on the gain. Ouch!

While we are at it, let us mention two other tax items that might be of interest. The \$25,000 allowance for rental losses for actively managed real estate phases out when adjusted gross income reaches \$100,000 and is completely eliminated when AGI reaches \$150,000. Secondly, we will mention a fairly obscure but very lucrative tax benefit relating to variable deferred annuities purchased before October 21, 1979. The IRS has issued a private ruling letter that the heirs can take a lump-sum distribution TAX FREE - a huge savings. Oh, just one more catch - the original buyer had to die before the scheduled annuity starting date.