Risk Premiums and Political Cycle Sentiment: Exploring the Role of Small Cap Valuations

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Abstract
A pricing anomaly has been identified in the financial economics literature concerning market returns and the presidential political cycle, but it has yet to be fully explained. Monthly market return data from 1927 to 2018 shows the average return in excess of the risk free rate is higher when the president in office is a Democrat. Previous studies attribute this differential to either differences in market and size risk or systematic positive surprises resulting from the policy decisions of Democrat presidents. Recent returns data and sub-period data appears to conflict with these studies. This analysis uses a five factor risk based conditional model and the Fama-Macbeth regression method to locate which type of asset is responsible for the premium, and the nature of the risk premium involved. This may lead to a connection between a specific factor premium and some characteristic associated with democrat administrations, or possibly a behavioral mispricing on the part of individual investors in regard to the presidential cycle.
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I. Introduction

Multiple studies have sought to explain why average U.S. stock market returns are higher when a Democrat holds the executive office. Santa-Clara and Valkanov (2003) found a connection between this return differential and portfolios sorted on the basis of market capitalization. Sy and Zamen (2011) approach the question using size-sorted portfolios with a conditional version of Fama and French’s (1992) three-factor pricing model. They find there is a statistically significant difference between the market and size factor loadings between administrations, and after allowing risk to vary the abnormal Democrat returns disappear.

Neither model specification allows investor sentiment to play a role in the cross section of returns. Baker and Wurgler (2006) argue it is a mistake to assume the cross section of returns depends only on the cross section of systematic risks. They present evidence showing investor sentiment can have significant effects on the expected value of returns, especially for firms with highly subjective valuations that are the riskiest and costliest to arbitrage. These small, speculative, hard to arbitrage firms are the same firms previous studies have identified as the main source of abnormal Democrat returns.

II. Research Methods

The above graphs show values and distributions of each of the factors used in this analysis along with formulas detailing their construction. The chart to the right shows the values for the Baker-Wurgler investor sentiment index, as well as the version of the index that is orthogonal to the business cycle. Democratic and Republican administrations are also represented as a binary variable.

The empirical investor sentiment indices used in this analysis are from Baker and Wurgler (2006), and available on-line (Baker website). Baker and Wurgler base their investor index on one underlying principle of sentiment:

1. Closed-Fed discussions. This is an increasing proxy for sentiment as it is possible for closed and top officials to make false or partial statements about the state of the economy that can change public sentiment.

2. Financial press. The tone of coverage of the economy in the financial press is measured. The tone is measured by the number of positive or negative words in the coverage.

3. News. The value of newspaper articles in the financial press is measured. The sentiment is measured by the number of positive or negative words in the coverage.

4. Economic Policy. The tone of coverage of the economy in the economic policy press is measured. The tone is measured by the number of positive or negative words in the coverage.

In each case, the abnormal Democrat returns are positive or negative.

The reported sentiment index is the difference between the sentiment proxied by these measures and the sentiment proxied by the returns for the market and size factor.

This analysis tests Sy and Zamen’s conclusions for the subperiod 1957-2018, and extends the literature by adding the momentum and quality factors to their 3-factor conditional model. The second stage of this analysis controls for investor sentiment in both a 3-factor and a 5-factor model.

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References