Stock Market Perspective: Bet Against Congress for Profits?

A more accurate title might be "Can Politics and Investing Mix?" If one reads the *Wall Street Journal's* editorial and op-ed pages, it is not unusual to see opinions by those who share the paper's mainly right-wing political philosophy. One idea that pops up repeatedly is that Congress is the source of many of our economic troubles, so the country would be better if it met far less frequently (or perhaps not at all when there is a Republican in the White House).

If one holds such a belief, then it may be "logical" to conclude that stock investments would do better if Congress met less. What about owning stocks when Congress is not in session and moving to cash when it is?

One right-wing[1] commentator, Eric Singer, a lawyer and corporate finance executive, believes that and has some data to back up his position. About five years ago, he started a mutual fund implementing that idea for the most part. It is the Congressional Effect Fund (ticker CEFFX). I will look at how the fund has performed later. He has also written a book on the topic.

The idea that it is better to own stocks when Congress is not meeting is not new. In 1992, he wrote a *Barron's* article titled "Legislator Go Home" reporting on research he had done back to 1978 supporting the concept. He ended the article with a proposal: "If Congress stays home, let's pay them a big bonus, maybe keyed to a percentage of the profits they'd create just by not doing anything. In other words, let's reward them for sitting on their hands, an activity they've shown a supreme talent for anyway." Another study, by others, shows the effect has held for the entire history of the Dow Jones Industrials.

The graph, which is from the fund's web site, shows research on the effect back to 1965. It makes a seemingly strong case that the effect should be a good way to time the market.

Before looking at how the fund has performed, we need to ask if the idea is a sound one for investment management. After all, it could be another spurious correlation like the Super Bowl Indicator[2], which Singer mentions in the

[1] I assume that anyone who is interviewed and praised by the web service "RightWingNews" fits that description.

[2] I have discussed it before in what I hope is a light-hearted way. It says that it is bullish for stocks if a team from the pre-merger (in 1968) National Football League (NFL) wins the Super Bowl and bearish if a team from the old American Football League does. It had an almost perfect record for quite awhile, but has been less accurate since it has been publicized. It is an example that if one looks enough, one can find a strong correlation between some two unrelated data series.

The Baltimore Ravens won the most recent one, so what does that portend? I don't think we can tell due to changes that have taken place. The Ravens moved from Cleveland where they were the Browns. (The current Cleveland Browns are an expansion team). To placate the city of Cleveland for the loss of the team, the Ravens

Barron's piece. The fund's web site lays out its case for the effect. "As government has gotten bigger at an accelerating rate, the Advisor believes one of the biggest risk to investors in today's market is legislative risk–the risk that the rules will change for an industry or for the country." Even if we accept this as valid, which is debatable, why should the market react primarily when Congress is in session? The stock market supposedly is evaluating the future prospects of the economy and individual firms, so unless Congress does something not anticipated, it should not matter whether or not it is in session. Most of the legislation is expected although there are a few surprises such as the last minute deal to avoid the "fiscal cliff" at the start of the year. Moreover, the effects of Congressional actions on the economy take some time to play out and do not always work out as well or as badly as first thought. The "sequestration" that started at the beginning of March is and will be an example. The web site has a couple of examples of Congressional action, one a hearing and one a House bill, that were followed by strong down days in particular sectors. I think it would not be hard to find examples that were followed by good gains in some or all of the market.

Congress is generally held in low regard and many think it hurts the economy. Is there a way to profit from that thinking?

Historically, stocks have done the best in the November-January period. Until recent years when it does not seem to be able to pass a real budget by the beginning of the fiscal year at the start of October, Congress has often not been in session for much of that three month period. Maybe part of the Congressional effect is due to seasonality in stocks. (Singer likely would argue the causality goes in the opposite direction.) I haven't researched that, partially due to effort it would take to find out when Congress is meeting, and I have no plans to do so.

The fund started in May 2008 and has never been very large. It currently has about $12 million in assets, which makes it tiny in the mutual fund universe. That is not necessarily bad since it can provide nimbleness not available to huge funds. However, as we shall see, for the most part that is irrelevant. Another drawback is that fund expenses tend to be a higher percentage for very small funds, and for CEFFX, the expense ratio is capped, so the Advisor is subsidizing the fund to some extent.

Singer says on the part of the web site geared to advisors "when I launched CEFFX, my goal was to match broad market returns while mitigating the political risk on investments associated with Congress in session." I find that interesting because in 2010 he told RightWingNews "my goal for the fund is to beat or match the market over time, while taking less risks." We will see why now he only hopes to match the broad market. However, risks are reduced since Congress meets about 2/3 of the time, meaning the fund is in cash much more than it is in the market.

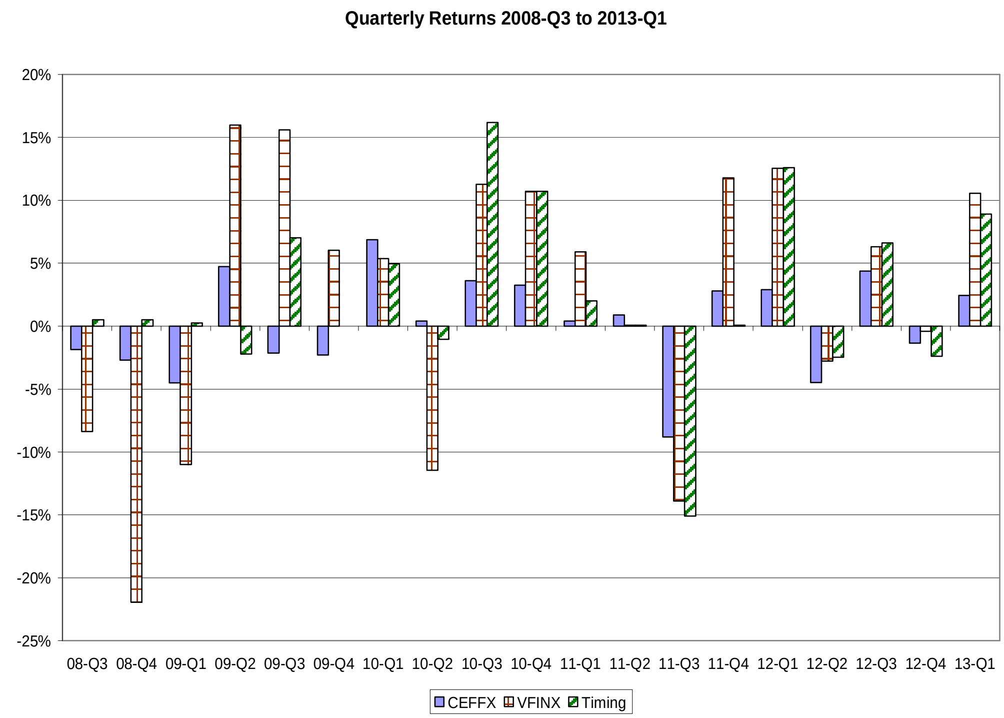
According to its prospectus, the fund implements the basic strategy on at least 90% of its assets. Up to 10% may be invested in issues that the "Adviser believes may be positively or negatively affected by market responses to Congressional activity or anticipated Congressional activity" regardless of being in session or not. Congress is considered to be in session if it is open for legislative business, excluding committee meetings and pro forma sessions. When not in session the fund will buy S&P 500 futures and/or an index fund that tracks it. Because Congress often has short periods when it is not in session according to the fund's definition,

were not allowed to take the Browns' history with them because it was kept for the future expansion team. The old Browns were an NFL team that moved to the American Conference when the leagues merged. Since the Ravens do not have the Browns history, can we tell if they are an old NFL team? Maybe we can decide once we know how stocks have done this year. ☺

such as long weekends to go back to districts for “work periods,” there is a lot of turnover of the fund’s assets. The high turnover results in transaction costs that are higher than those of most mutual funds. That is a factor not included in the graph shown on the prior page.

Let’s look at how the fund has done and compare its performance to the Vanguard Index 500 fund (ticker VFINX) that owns all of the stocks in the S&P 500 and has very low expenses. We’ll also look at market timing using the “Triple-40” model I feature in the TAA newsletter. It is based on trends in the S&P and interest rates. We will apply it to VFINX for purposes of comparison although restrictions by Vanguard on how often VFINX can be traded would make such impossible. Similar returns could be obtained using an ETF that tracks the index.

The third quarter of 2008 was the first full one for CEFFX, so I will start with it. There have been 15 quarters since then, and the graph above shows how that fund, VFINX, and VFINX with timing did in each of the quarters. The solid blue bars are the CEFFX returns, the cross-hatched red bars show VFINX’s performance while the diagonal striped green bars provide information about using timing. Due to being out of the market about 2/3 of the time, the returns for the Congressional Effects fund tend to be smaller in either direction than the others. While VFINX had four quarters in which it fell by more than 10%, that was the case using timing for only one, the third of 2011.



Over the 15 quarters, the compounded annual returns were a miniscule 0.8% for CEFFX, 8.5% for VFINX, and 12.0% for timing. The largest drawdown, a fall from a peak to a low point over the period was 21.8% for CEFFX, 47.2% for VFINX, and 19.8% for timing. So CEFFX was considerably less risky using that measure than the broad market due to its reduced exposure. However, using timing reduced the risk even more since it resulted in better times both to be in and out of the market.

The graph on the next page shows how each of the three did starting with the third quarter of 2008. Except for a quick drop in the second half of that year that was recovered for the most part in early 2009, CEFFX (the solid black line) has pretty much followed the zero line. The broad market represented by VFINX (the dotted red line) continued its plunge that began in 2007 into March 2009 before pretty much steady gains since then. Timing (the dashed green line) was laregely out of the market until the second quarter of 2010, so it was able to avoid the large drop in VFINX. Stocks had risen quite a bit before the timing model gave a buy signal. However, as the graph shows, avoiding bad times in the markets is the key to longer term superior returns with far less risk than buying and holding.

To wrap up, the Congressional Effects fund has not come close to living up to Singer's hope for it. It has reduced risk, but over the 15 full quarters it has been around, one would have done almost as well with no risk holding a money market fund. There are various possible explanations as to why the enticing chart a couple pages back has not resulted so far in a good investment plan. It may be a spurious correlation like the Super Bowl Indicator, or the nature of today's contentious Congress that often has trouble doing much of significance may mean the markets no longer pay as much attention to what is going on day-to-day in Washington. Also, the high turnover and the resulting transaction costs might have wiped out a good portion of the hypothetical advantage. I suspect there is a combination of two or three of these.

Do politics and investing mix so one can take advantage of a Congress that is generally held in low regard? Not likely. One commentator pointed out that a better plan would be to get in touch with one's Representative and Senators or getting active to try to point Congress in the "right" directions.