S&P Dow Jones Indices
A Division of S&P Global

Sector Effects During Elections

"When we got into office, the thing that surprised me most was to find that things were just as bad as we'd been saying they were."

- John F. Kennedy

Contributors

Anu R. Ganti, CFA
Senior Director
Index Investment Strategy
anu.ganti@spglobal.com

Craig J. Lazzara, CFA
Managing Director
Global Head
Index Investment Strategy
craig.lazzara@spglobal.com

EXECUTIVE SUMMARY

The value of stock selection skill rises when dispersion is high; a larger gap between winners and losers means that active equity managers have a better chance to display their selection abilities.[1] This logic also applies to active managers operating at a higher level of aggregation, for example by expressing tactical market views through sector rotation. **The importance of sectors tends to be greater than average during the Novembers when U.S. federal (and especially presidential) elections take place.** Sector allocation decisions can add (or subtract) greater value in these months. British and Canadian data are consistent with the U.S. results.

BACKGROUND

Dispersion, or the index-weighted standard deviation of returns, gives us a convenient way to measure the potential benefit of active decisions.[2] Successful active managers—be they stock pickers, sector rotators, or factor investors—can add more value when dispersion is high than when it is low.[3] Dispersion also provides a useful framework for understanding the importance of sectors in generating returns.

We can compute dispersion at various levels of granularity. The dispersion of 500 stocks will always be greater than the dispersion of 11 sectors, as Exhibit 1 illustrates. In addition, the capitalization of the average sector is approximately 10 times larger than the capitalization of the average stock. **Sectors thus offer more capacity** for active managers to add value, as shown in Exhibit 2.[4]

[1] Ganti, Anu, "Showtime for Active Managers," S&P Dow Jones Indices, March 2020.

[2] See Edwards, Tim and Craig J. Lazzara, "Dispersion: Measuring Market Opportunity," S&P Dow Jones Indices, December 2013.

[3] And, sadly, lose more value if their decisions are wrong. See Lazzara, Craig, "The Value of Skill," S&P Dow Jones Indices, March 20, 2015. See also Chan, Fei Mei and Craig J. Lazzara, "Gauging Differential Returns," S&P Dow Jones Indices, January 2014.

[4] See Edwards, Tim and Craig J. Lazzara, "Sector Effects in the S&P 500," S&P Dow Jones Indices, March 2019. (Note that the vertical axis of Exhibit 2 is in logarithmic scale.)

Dispersion gives us a convenient way to measure the potential benefit of active decisions.

Exhibit 1: S&P 500® Stock and Sector Dispersion
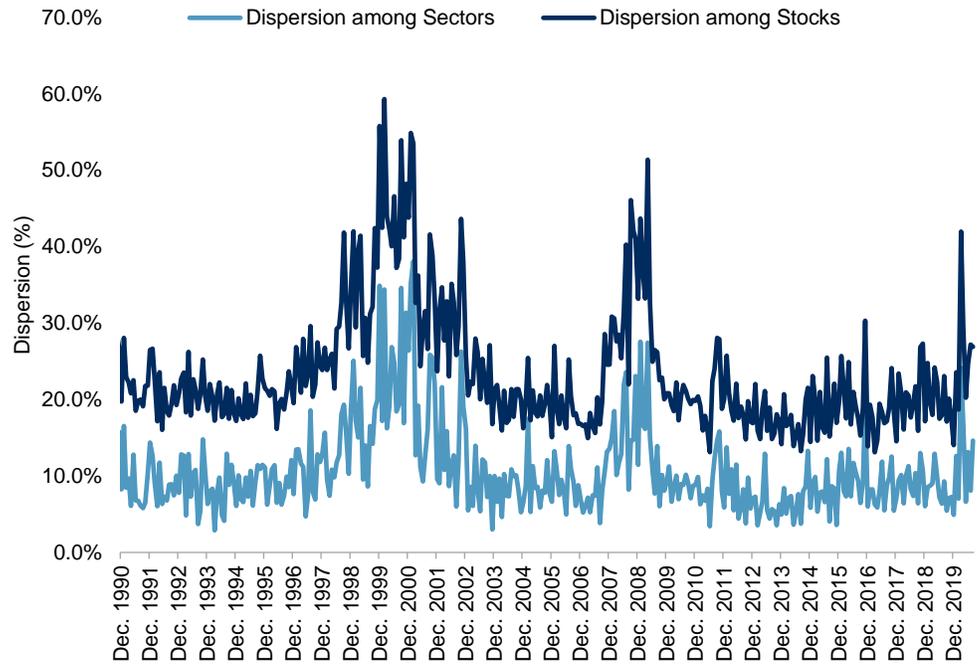
Source: S&P Dow Jones Indices LLC. Data from January 1990 through August 2020. Chart is provided for illustrative purposes.

The dispersion of 500 stocks will always be greater than the dispersion of 11 sectors…

Exhibit 2: Sectors Offer a Trade-Off between Capacity and Dispersion

…and the market cap of the average sector is approximately 10 times larger than that of the average stock.

Thus, sectors offer more capacity for active managers to add value.
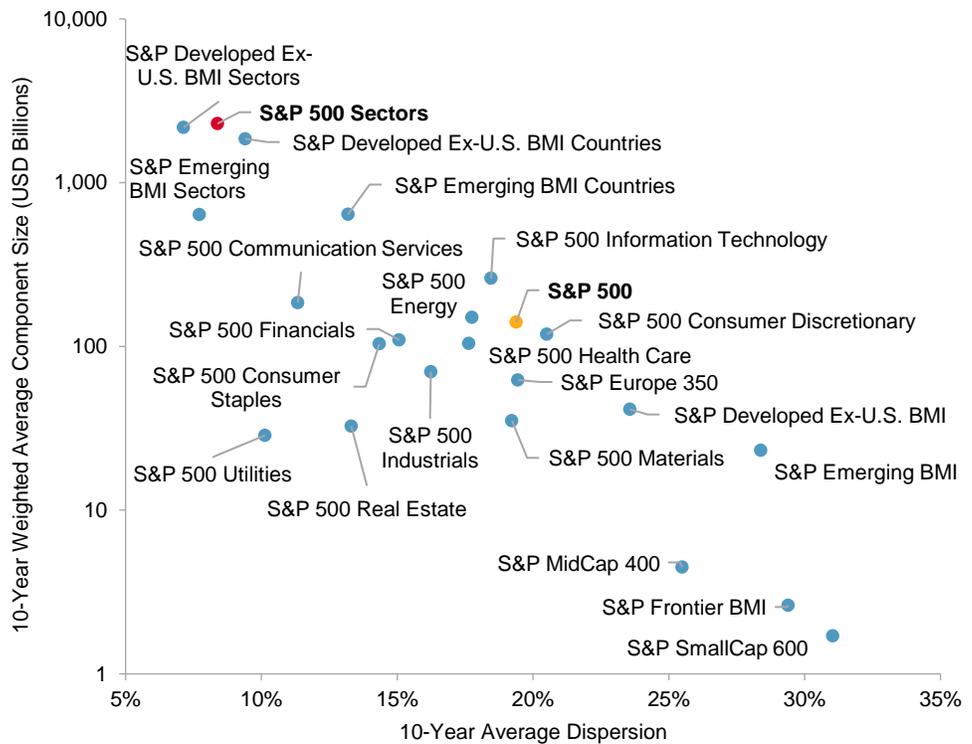
Source: S&P Dow Jones Indices LLC. Data as of June 2020. Chart is provided for illustrative purposes.

Total dispersion can be understood as a combination of two components…

Total dispersion can be understood as a combination of two components: dispersion *across* sectors and the average dispersion of stocks *within* each sector. Their relationship is mathematically Pythagorean: the sum of the squares of cross-sector dispersion and average within-sector dispersion is approximately equal to the square of the market's overall dispersion.[5]

We can use this relationship to analyze the importance of cross-sector effects in total market dispersion. Exhibit 3 shows, for the S&P 500, the ratio of squared cross-sector dispersion to the square of total dispersion. We can interpret this ratio as the contribution of sectors to total dispersion.

…dispersion across sectors and the average dispersion of stocks within each sector.

Exhibit 3: Contribution of S&P 500 Sectors to Total Dispersion
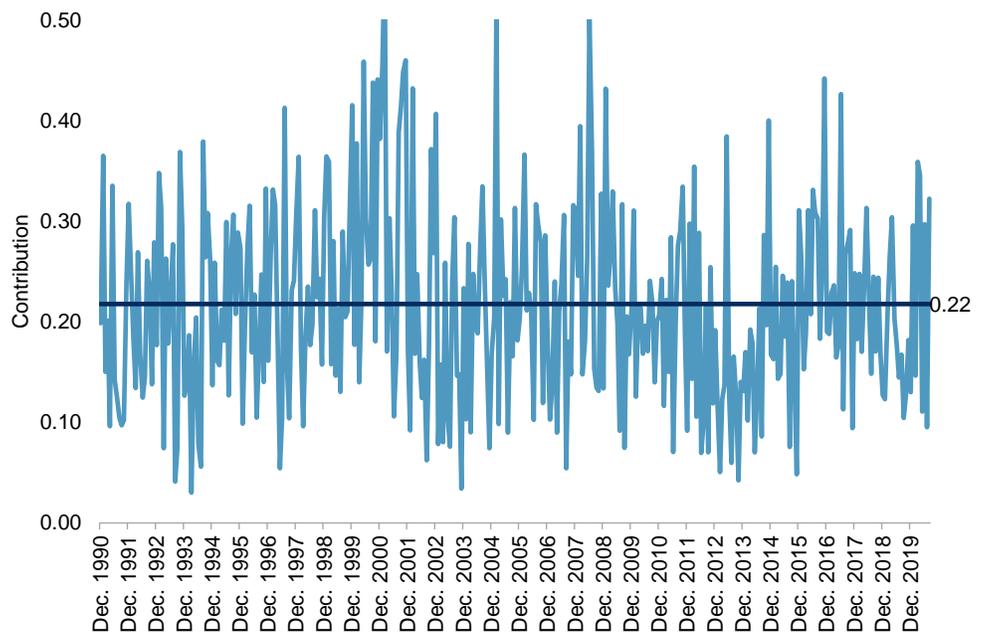
We can use their Pythagorean relationship to analyze the importance of cross-sector effects in total market dispersion.

Source: S&P Dow Jones Indices LLC. Data from January 1990 through August 2020. Chart is provided for illustrative purposes.

On average, 22% of the market's total dispersion is contributed by cross-sector effects.

The historical average since 1990 is 0.22. In other words, **on average, 22% of the market's total dispersion is contributed by cross-sector effects.**

---

[5] "Sector Effects in the S&P 500," *op. cit.*, pp. 14-16.

THE NOVEMBER EFFECT

This 22% is the *average* importance of sectoral dispersion; it turns out that the effect is stronger in some months than others. Exhibit 4 shows that **the highest average cross-sector effect occurs in November**, the month of U.S. presidential and congressional elections.

Exhibit 4: Average Cross-Sector Effects in the S&P 500 Were Highest in November
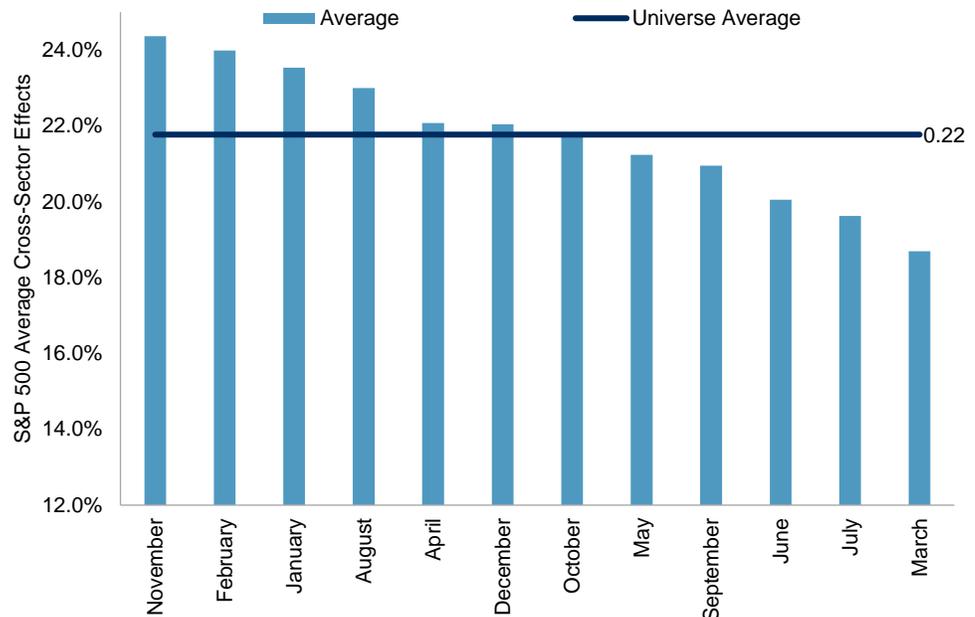
The highest average cross-sector effect occurs in November…

…the month of U.S. presidential and congressional elections.

Source: S&P Dow Jones Indices LLC. Data from January 1990 through August 2020. Chart is provided for illustrative purposes.

Of course, elections don't occur every November, and even when they do, some elections may be more important than others.[6] It seems logical that presidential election years would be more consequential than years with only congressional elections, and that Novembers in congressional election years would be more consequential than Novembers with no federal elections at all. Exhibit 5 shows that this is true. To construct this exhibit, we categorized the months in our database into four buckets: presidential election Novembers, congressional election Novembers, non-election Novembers, and non-November months. Results were particularly striking in Novembers with presidential and congressional elections. **Cross-sector effects in the S&P 500 were greater than average in 71% of the presidential election months** and 63% of the congressional election months. In contrast, cross-sector effects were above average in only 47% of non-federal election Novembers and 44% of months other than November.

Of course, elections don't occur every November, and even when they do, some elections may be more important than others.

---

[6] Elections for U.S. president are held every four years, on the first Tuesday after Nov. 1; all members of the House of Representatives and one-third of the Senate also stand for election then. Mid-term elections (for the entire House of Representatives and one-third of the Senate) occur two years after each presidential election, also on the first Tuesday after Nov. 1. There are no federal elections in odd-numbered years.

Cross-sector effects in the S&P 500 were greater than average in 71% of the presidential election months…

Exhibit 5: S&P 500 Cross-Sector Effects Strongest during Presidential Election Months
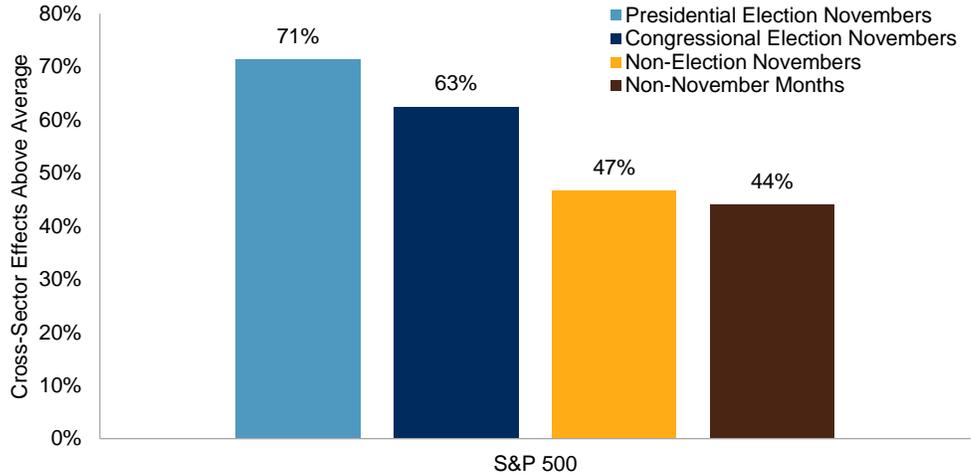
Source: S&P Dow Jones Indices LLC. Data from January 1990 through August 2020. Sample size includes 338 non-November months, 7 presidential election Novembers, 8 congressional election Novembers, and 15 non-election November. Chart is provided for illustrative purposes.

…whereas they were above average in 47% of non-election Novembers and 44% of months other than November.

Interestingly, for mid- and small-cap companies, cross-sector effects in congressional election months outpaced presidential months, while sector effects of election Novembers still dominated the rest of the year. For example, we observe in Exhibit 6 that in mid caps, cross-sector effects were greater than average 83% of the time in Novembers with only congressional elections, outpacing presidential election Novembers at 67%. We see similar results in small caps.[7]

For mid and small caps, cross-sector effects in congressional election months outpaced presidential months…

Exhibit 6: S&P 400 and S&P 600 Cross-Sector Effects Strongest during Congressional Election Months

…while sector effects of election Novembers still dominated the rest of the year.
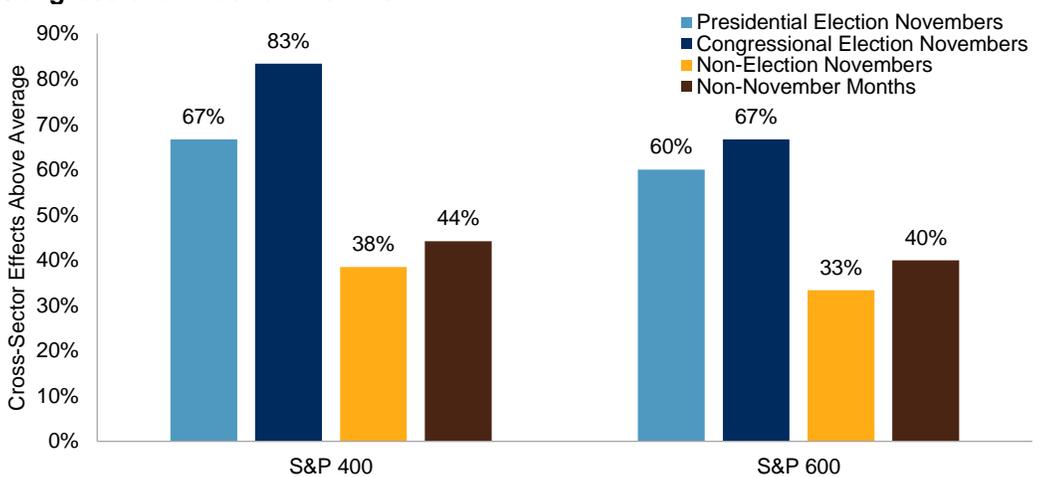
Source: S&P Dow Jones Indices LLC. Data from January 1995 through August 2020 for the S&P 400™ and from April 1997 through August 2020 for the S&P 600™. Sample size for the S&P 400 includes 283 non-November months, 6 presidential election Novembers, 6 congressional election Novembers, and 13 non-election Novembers. Sample size for the S&P 600 includes 258 non-Novembers, 5 presidential election Novembers, 6 congressional election Novembers, and 12 non-election Novembers. Chart is provided for illustrative purposes.

---

[7] It's interesting to speculate on why this might occur. One hypothesis is that smaller companies are more domestically focused, and that congressional-only election years are less likely to be dominated by foreign policy controversies.

INDEX INVESTMENT STRATEGY   5

These results are not dependent on capitalization weighting. The S&P 500 Equal Weight Index showed results consistent with its cap-weighted counterpart, as seen in Exhibit 7.

The S&P 500 Equal Weight Index showed results consistent with its cap-weighted counterpart.

Exhibit 7: Cross-Sector Effects in the S&P 500 Equal Weight Index Strongest during Presidential Election Months

Source: S&P Dow Jones Indices LLC. Data from January 1990 through August 2020. Sample size includes 338 non-November months, 7 presidential election Novembers, 8 congressional election Novembers, and 15 non-election Novembers. Chart is provided for illustrative purposes.

APPLICATIONS FOR INTERNATIONAL MARKETS

The tendency for the importance of sectors to increase around presidential elections is not limited to the U.S.

The tendency for the importance of sectors to increase around presidential elections is not limited to the U.S.; it also emerges in some international markets. In most parliamentary systems, general elections are not held on a fixed calendar schedule. When we performed a similar analysis for the U.K. and Canadian markets, however, the pattern was consistent with what we observed in the U.S. During months when general elections took place, cross-sector effects were greater than their historical average.

Exhibit 8: Cross-Sector Effects Tend to Increase during British and Canadian General Elections

When we performed a similar analysis for the U.K. and Canadian markets, the pattern was consistent with what we observed in the U.S.
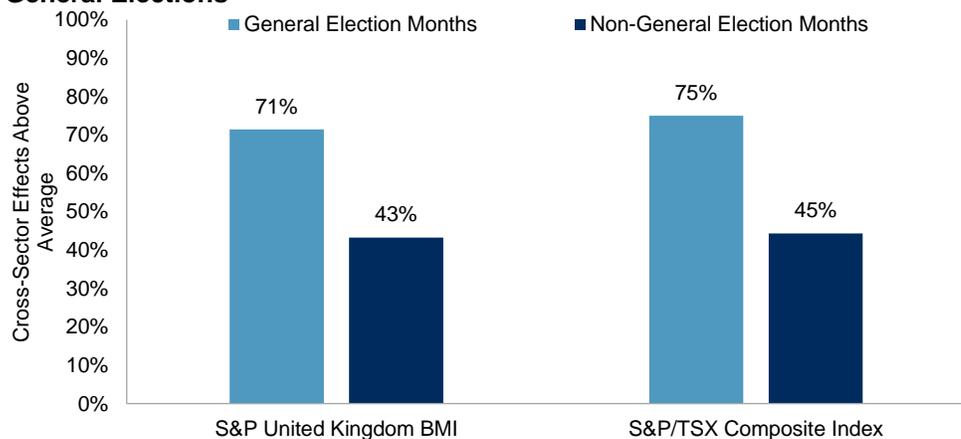
Source: S&P Dow Jones Indices LLC. Data from February 1995 through August 2020 for the S&P United Kingdom BMI and from August 1995 through May 2020 for the S&P/TSX Composite Index. Sample size for the S&P United Kingdom BMI includes 7 general election months and 300 non-general election months. Sample size for the S&P/TSX Composite Index includes 8 general election months and 293 non-general election months. Chart is provided for illustrative purposes.

The value added of any active strategy is a function of the manager's skill and the ambient level of opportunity…

…and the 2020 U.S. presidential election could provide unusual opportunity.

FINAL THOUGHTS

This analysis has significant implications for active managers who pursue sector rotation strategies. The value added of any active strategy is a function of the manager's skill and the ambient level of opportunity. History tells us that **the contribution of sectors to total dispersion is likely to rise as we approach the November 2020 U.S. presidential election**, which means that the importance of skillful sector picks will increase. We know well that greater *opportunity* for outperformance does not guarantee *actual* outperformance.[8] But for investors with a genuine ability to rotate across sectors tactically, this November could be a month of unusual opportunity.

---

[8] See, e.g., Ganti, Anu, "Glory or Embarrassment?" S&P Dow Jones Indices, April 2020.

S&P DJI RESEARCH CONTRIBUTORS		
Sunjiv Mainie, CFA, CQF	Global Head	sunjiv.mainie@spglobal.com
Jake Vukelic	Business Manager	jake.vukelic@spglobal.com
GLOBAL RESEARCH & DESIGN		
AMERICAS		
Gaurav Sinha	Americas Head	gaurav.sinha@spglobal.com
Laura Assis	Analyst	laura.assis@spglobal.com
Cristopher Anguiano, FRM	Analyst	cristopher.anguiano@spglobal.com
Nazerke Bakytzhan, PhD	Analyst	nazerke.bakytzhan@spglobal.com
Smita Chirputkar	Director	smita.chirputkar@spglobal.com
Rachel Du	Senior Analyst	rachel.du@spglobal.com
Bill Hao	Director	wenli.hao@spglobal.com
Qing Li	Director	qing.li@spglobal.com
Berlinda Liu, CFA	Director	berlinda.liu@spglobal.com
Lalit Ponnala, PhD	Director	lalit.ponnala@spglobal.com
Maria Sanchez, CIPM	Associate Director	maria.sanchez@spglobal.com
Hong Xie, CFA	Senior Director	hong.xie@spglobal.com
APAC		
Priscilla Luk	APAC Head	priscilla.luk@spglobal.com
Arpit Gupta	Senior Analyst	arpit.gupta1@spglobal.com
Akash Jain	Associate Director	akash.jain@spglobal.com
Anurag Kumar	Senior Analyst	anurag.kumar@spglobal.com
Xiaoya Qu	Senior Analyst	xiaoya.qu@spglobal.com
Yan Sun	Senior Analyst	yan.sun@spglobal.com
Tim Wang	Senior Analyst	tim.wang@spglobal.com
Liyu Zeng, CFA	Director	liyu.zeng@spglobal.com
EMEA		
Andrew Innes	EMEA Head	andrew.innes@spglobal.com
Alberto Allegrucci	Senior Analyst	alberto.allegrucci@spglobal.com
Leonardo Cabrer, PhD	Associate Director	leonardo.cabrer@spglobal.com
Andrew Cairns, CFA	Associate Director	andrew.cairns@spglobal.com
Jingwen Shi	Senior Analyst	jingwen.shi@spglobal.com
INDEX INVESTMENT STRATEGY		
Craig J. Lazzara, CFA	Global Head	craig.lazzara@spglobal.com
Chris Bennett, CFA	Director	chris.bennett@spglobal.com
Fei Mei Chan	Director	feimei.chan@spglobal.com
Tim Edwards, PhD	Managing Director	tim.edwards@spglobal.com
Anu R. Ganti, CFA	Senior Director	anu.ganti@spglobal.com
Sherifa Issifu	Analyst	sherifa.issifu@spglobal.com

GENERAL DISCLAIMER