



Investing Conundrum in the 3rd year of a Presidency

The 3rd year of a presidential cycle seems to have real significance according to Jeremy Grantham, co-founder of the investment management firm GMO and one of the best money managers in the world, in my opinion.

“Highly volatile stocks have outperformed low-risk stocks by an astonishing average of 18% a year since 1964. Also, out of 19 presidential 3rd years, there was only one down year, and that was -2%!”

Wow!

Volatile stocks returned 18% more than less volatile, low-risk stocks - that’s quite a conundrum for low risk investors wary of putting their money in highly volatile stocks that they consider inferior.

Will History Repeat?

With 2011 just around the corner, we are on the verge of the 3rd year of the Obama Presidency; will this historical pattern will reoccur?

Upon reflection... this trend seems pretty obvious. After all, the Federal Reserve typically raises rates to cool the economy in the 1st and 2nd years of a presidency; then lowers rates in the 3rd year to encourage borrowing, spending and investment, all of which “conveniently” stimulate the economy in-time for the incumbent president’s re-election.

Therein lays the “Advisors Dilemma”. How do you invest in 2011 when:

- 1) You believe that high-quality stocks will handily outperform low-quality stocks over the next 5 years; but
- 2) Are told that low-quality stocks could fare significantly better in 2011.

Risk May Flourish

Grantham believes interest rates will stay low in 2011, and expects “the line of least resistance to be a higher market and for risk to flourish.” Therefore markets could more easily move higher than lower.

And were “risk to flourish,” the less-volatile S&P 500 could move from its current 1200 level to 1400, and riskier stocks could cause the NASDAQ to go further up from 2500 to 3500. Heady stuff!

So what should high-quality stock investors do when the world is on a speculative buying spree?

Grantham believes things may be a little different this time because high-quality companies are extremely cheap relative to the market and could also perform well in 2011, giving us conservative investors to a place to invest.

Stay the Course

To investors, I’d say ignore statistical “opportunities” and continue using the right measures for your stock evaluations – consistently growing earnings, good dividends, a strong balance sheet, and a reasonable stock price.

If you want to add a little lighter-fluid to the mix, buy a small cap or a NASDAQ play, but keep it reasonable.

Oh... and expect to be annoyed as low-quality stocks go up and up in a speculative fever, but smile knowing that that party will end, most likely very badly.

Emerging Markets

EVERYONE knows that emerging markets are the new big thing. And Grantham believes we may still have a few more years of good performance before this asset class bubbles over, this is due to the fact that emerging economies are still growing at rates north of 6% compared to 2% stateside.

Gold

Grantham’s take on gold: “It pays no dividend, cannot be eaten, and is mostly used for nothing more useful than jewelry.” He echoes my views – that gold is basically an unproductive asset. And in the longer run, more useful natural resources such as forests, agriculture, and even real estate are more certain to resist inflation or a currency crisis than gold.

Grantham Recommends

Weighting your portfolio towards high-quality U.S. stocks; being moderately overweight Emerging Markets; being moderately underweight other global stocks; being heavily underweight lower quality U.S. stocks (speculation be damned!); and carrying extra cash to ride out volatility over the coming years.

So, good luck with investing through 2011's conundrum!