BESSEMER TRUST

A Closer Look

Elections and Markets Q&A

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In Brief

- **We share Bessemer's investment approach in the lead-up to the November elections given what is likely to be a period of heavy news flow and at least some uncertainty in the investment landscape.**
- **Specifically, we explore the impact of politics on financial markets generally and focus on several key questions related to the 2020 elections and Bessemer's portfolio positioning.**
- **As the situation inevitably evolves over the next several months, we expect to provide additional updates.**

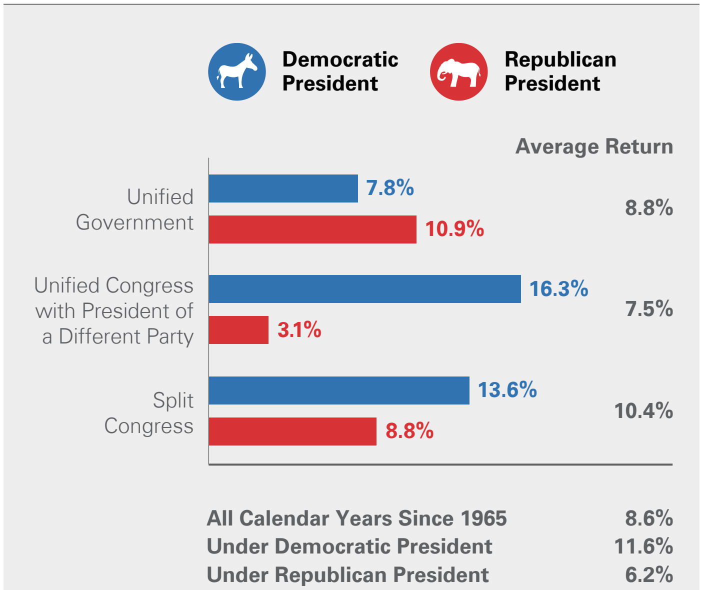
As the November 2020 presidential and congressional elections come squarely into view, we want to share the investment team's approach to navigating what is sure to be a period of intense news flow and at least some degree of uncertainty in the investment landscape. With more than three months of twists and turns ahead, we expect to provide additional updates on the evolving situation, and we believe our framework provides context for our approach to portfolios over this time.

In this *A Closer Look*, we explore two enduring themes: How much do politics matter for markets, and how can an investor have an edge in anticipating political shifts? In addition, a few initial questions are arising related to 2020 in particular: Should we throw out the polls? Is this election cycle going to be completely different due to COVID-19? And would a "blue wave" (with Biden winning the White House and the Democrats taking the Senate and retaining the House) sink the markets or be a prelude to calmer seas? Finally, does the vice president matter? We tackle each of these questions in the pages that follow in what we hope will be a data-driven, unbiased, and humble approach to a complicated endeavor.

Question: How much does politics matter for markets?
Answer: Stable institutions matter; waxing and waning of political parties much less so.

Stable political institutions, including a dependable legal framework around property and financial ownership, are important cornerstones for markets, encouraging investors to allocate capital to enterprises, in turn driving growth in the economy and returns. Developed markets, which generally score better in this area, have traded at a premium to emerging markets for this reason, among others. In an extreme scenario in the U.S. or Europe, if such a framework is seriously compromised, politics can matter significantly for markets. At the other end of the spectrum, specific legislation can matter significantly for a particular stock or sector. In many other cases, however, politics is not a core driver of markets even as it may garner significant attention in the media and financial press.

Exhibit 1: S&P 500 Average Annual Performance Under Partisan Control Scenarios — 1965–2019



Note: Data excludes 2001–2002 due to Senator Jeffords changing parties.

Source: Strategas Research Partners

As a case in point, a historical analysis from 1965 through 2019 shows no meaningful correlation between Republican or Democratic leadership and market returns. Exhibit 1 provides the full data set under various scenarios. One takeaway is that in recent years there has been a statistically significant higher return with a split government (one party in the White House, one holding a congressional majority) in comparison with one party dominating the White House, Senate, and House.

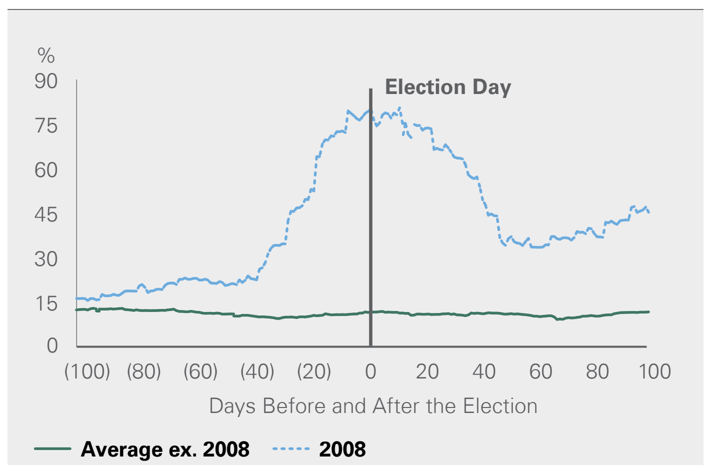
Another takeaway is that volatility has tended to increase for markets into presidential elections when the economy is faltering. 2008 is a good example of this — the presidential election was heating up just as Lehman collapsed and the financial crisis intensified (Exhibit 2). Taking this election out of a historical analysis of volatility suggests that the increases ahead of other presidential elections over this period were more muted. As we discuss on page 4, there are some key reasons why 2020 may see volatility increases beyond the usual pattern.

Question: How does an investor have an edge in anticipating political shifts?
Answer: We favor a data-driven approach and reliance on objective experts.

As long-term investors focused on the preservation of capital and strong risk-adjusted returns, the key to our success is in picking the best companies and securities over time and having a thoughtful asset allocation aligning with clients' specific goals. If there is a major shift in the investment landscape, it is important that we are prepared both to seize the best opportunities and also to mitigate risk for our clients. Understanding the various scenarios the upcoming election presents, an expected probability of each, and steps we may take to protect portfolios and adjust to the new environment are the most important parts of our election analysis — without the speculative process of trying to correctly draw out the full Electoral College map in advance.

Acknowledging both the importance of this analysis and the complexity of it, we are partnering with a trusted, independent thought leader and research partner in this effort. Our work throughout election season will be reliant on the data and insights that Strategas Research Partners provides through our various interactions with

Exhibit 2: S&P 500 Rolling Realized 30-Day Annualized Volatility Before and After Election Day



As of June 30, 2020.

Source: Bloomberg

them. We look forward to sharing their views as the races unfold, and weaving them with our thoughts on the markets and portfolio positioning.

In light of the potential for added volatility surrounding this election season, Bessemer portfolios are maintaining their moderately defensive positioning headed into the fall. Additionally, our sector tilts can help buffer portfolios from politically driven market swings. For example, on an all-equity basis, portfolios are underweight the energy and financial sectors, two areas that could be impacted by the electoral outcome and resulting regulation. Moreover, our focus on active management further enables portfolios to minimize political risk. Portfolio managers are actively reassessing their portfolios in light of potential legislative adjustments, and portfolio teams are reviewing which positions they may add to or trim depending on election results and legislative priorities. However, given Bessemer's long-term investment horizon, we would expect most politically influenced portfolio adjustments to be minimal and in line with longer-term trends for each individual strategy.

Question: Is it time to throw out the polls?
Answer: Other sources are likely to be more useful in identifying the probabilities of various outcomes.

The 2016 election, the Brexit referendum, and other recent outcomes that defied polls have led many to question the effectiveness of polls as a data source. We think the scrutiny is well deserved but would provide a few caveats. Part of the issue with polls boils down to the combination of a binary outcome with a probabilistic approach. The results of the 2016 election were technically within the stated margins of error for most polls; however, those interpreting the polls may have not focused on the margin of error in their commentary at the time. Further, the national polls are more relevant for the popular vote but have been less useful in anticipating an Electoral College outcome. Additionally, some polls overrepresented college-educated voters. These factors will remain at play in 2020. For example, by Strategas' calculation, President Trump can lose the popular vote by four million votes and still win the presidential race through the Electoral College. Additional challenges with polls include differences between pools of *registered* voters and *likely* voters, the time-sensitive nature of when the poll is taken, and a reluctance of likely voters to reveal their preferences in a politically charged climate. We would note that even exit polls in 2016, which eliminate the problem of timing and registered versus likely voters, were not anticipating a Trump victory more clearly.

There are alternative data sources that may be more illustrative of voter trends in 2020 that we will be monitoring. One emerging area is betting markets, which are all the more popular in the recent absence of betting on live sports due to the COVID-19 situation. U.S. governing bodies generally frown upon Las Vegas-style betting over domestic elections, but commodities regulators have given the nod to a few futures markets designed to produce data for researchers, with some limits. The granddaddy of the field, the University of Iowa's Electronic Markets, has been running nationally since the early 1990s. It offers a winner-take-all market on the presidential popular vote and a vote-share market, as well as markets on congressional control. The more polished PredictIt, an online market run by New Zealand's Victoria University of Wellington, offers a wider range of election and other political bets. Since they exist for research purposes, both markets put a lid on your losses — and potential gains — to some degree. The Iowa market limits total bets to $500. PredictIt limits an individual's investment in any given contract to $850. There is also a U.K. betting market (Smarkets) that is technically only available to political junkies outside the U.S.

In the past month, as polls have moved decisively in favor of former Vice President Biden and the Democrats, these alternative sources have moved in a similar direction. In looking at University of Iowa's Electronic Markets, bettors are giving 53% odds that Biden wins and 53% odds that Democrats hold the House and take over the Senate. This compares to the FiveThirtyEight national polling average, which shows 50% favor Biden versus 42% for President Trump and 50% for Democrats to take over Congress versus 41% for Republicans.

Financial markets themselves can provide a sense of the probability that investors broadly are assigning to different outcomes. Historically, if the S&P 500 has been higher in the three months before an election, the incumbent party has won; if stocks have been lower in the three months before, the opposition party has won. This trend has held for every presidential election since 1984, and 87% of the time since 1928. The performance of financial market sectors also can be telling. In 2016, the financials and energy sectors rallied before the election, both of which were sectors perceived to benefit under a Trump administration based on his campaign priorities. This time around, we are continuing to monitor financials and also fossil fuel energy versus renewable energy. Another coincident indicator with President Trump's popularity has been the U.S. dollar, which has fallen of late.

Question: Does the COVID shock make 2020 unique, or do historical precedents still apply?
Answer: Voter turnout and links between the economy and election outcome are more uncertain in 2020.

One topic we are monitoring closely with the help of Strategas is the complexity of the mail-in ballots, absentee voting, and potential changes to voting procedures that may affect turnout. Additionally, most states offer early voting, which can include mail-in voting but can also include voting in person. It is important to note that voting online is not permitted for federal elections. States have various approaches and technological capabilities, and our focus is most acutely on swing states. Only five states (Oregon, Washington, Utah, Hawaii, and Colorado) have all mail-in ballots by default. The other 45 states plus D.C. have typically collected most of their residents' voting ballots on Election Day in person. With the exception of Arizona, where many already vote by mail, swing states' voting processes are likely to be tested this year. For instance, Virginia, Pennsylvania, and New Hampshire have all recently reformed their voting processes to make it possible and easier for all residents to vote via mail. Additionally, the required return date for mail-in votes to be counted varies by state with some allowing votes to be counted after Election Day (as long as they are timestamped on Election Day or sooner) and others requiring that the votes arrive by Election Day. This time gap difference may prove to be meaningful if mail-in voting proves to be the preferred voting method by many. Early voting in person is also permitted in some swing states. To the extent the election is close, this issue will be very important in our view.

Overall, we think it is prudent to put some probability on a scenario in which there may not be a clear winner on election night, and there may be debates regarding various state programs, similar to the "hanging chad" debacle of 2000. Additionally, if the vote is close and there are polling issues, the elected president may begin the presidency without conclusively winning. We have included in Exhibit 3 the state procedures of some of the key states to watch. All offer no-excuse mail-in voting; some states, like New York, do require an excuse to vote by mail.

Looking historically over presidential elections, the performance of the economy in the months before the election has been a key indicator of the fate of the incumbent — with stronger economic sentiment in the second quarter suggesting a higher likelihood of the incumbent being reelected. While the weaker economy in recent months is likely one of the reasons that President Trump's approval ratings have declined of late, we think it is worth questioning this historical pattern in light of how unusual this time is. Ahead of the election, there will be both a very weak second-quarter GDP print but also the potential for a strong first print of third-quarter GDP reported just a week before the election. Will the electorate focus on the absolute levels of growth or the probable improvement from the dire second quarter?

Another complication is that, while income levels normally track overall growth, in light of stimulus measures, average income levels *have not* declined during the COVID-19 crisis. Government support has offset wage losses at the aggregate level. Actually, those claiming unemployment benefits have received approximately $788/week on average, which is well above the approximately $300/week distributed in a normal environment. Another interesting data point is that spending for the lowest quartile of income earners

Exhibit 3: Swing States All Offer No Excuse Mail-In Voting, with Some Also Offering Early In-Person Voting

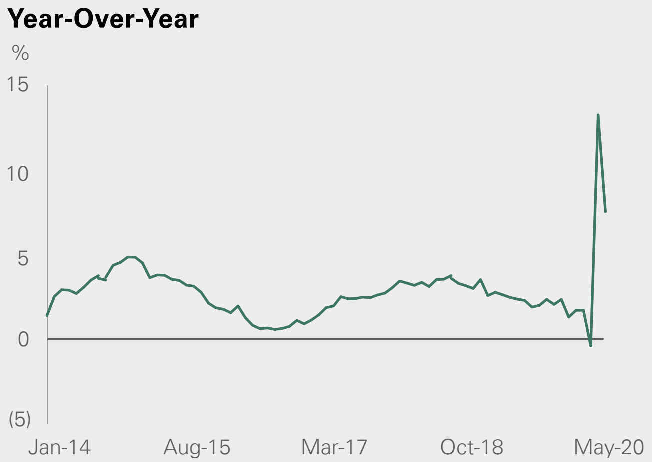
Key States	Early and Mail-In Voting Details
AZ	Many Arizonians already vote by mail, and the state is recommending that more residents vote early or by mail. It is recommended that voters mail in their ballots by October 28; all ballots must be received by 7 p.m. on Election Day.
FL	Ballots are accepted by mail or delivered to a county's Supervisor of Elections office and must be received by 7 p.m. on Election Day; it is recommended that voters mail in their ballots one week before the deadline. An online tracker is available for votes done via mail through a link within the Division of Elections' Voter Information Lookup or through their county Supervisor of Elections' website.
IA	Absentee ballots can be returned by mail; they cannot be delivered to the polling place on Election Day. All ballots must be postmarked the Monday before Election Day or earlier to be counted and must have arrived at the county auditor's office by noon on the Monday following Election Day.
MI	Voter ballot must be returned to the county clerk's office by 8 p.m. on Election Day.
NC	One witness is required to sign off on the vote by mail; typically, two witnesses are required. Ballots must be delivered by 5 p.m. on Election Day or be postmarked on or before Election Day and received by 5 p.m. on the third day after Election Day.
NH	Typically, there is no early voting available, but an exception was made to the mail-in voting rules this year due to COVID-19. Any New Hampshire voter can now apply for an absentee ballot and vote by mail before Monday, November 2. Ballots must be returned by 5 p.m. on Election Day.
OH	Absentee ballots are the first votes counted on Election Day. Ballots must be returned in person to the county board of elections by 7:30 p.m. on Election Day or mailed and be postmarked the day before the election to be counted.
PA	For the first time, after a law was passed last year, mail-in ballots are available for any qualified voter along with the absentee ballot option. Voters can track their mail-in ballot or absentee ballot online. All ballots must be received by the county election office at 8 p.m. on Election Day or delivered to the county election office by the deadline of that specific office.
VA	VA was the first state since the pandemic began to reform its voting requirements, eliminating the excuse requirement for mail-in voting. All votes via mail must be received by 7 p.m. on Election Day or postmarked on or before Election Day and received by noon on the third day after the election. Early voting in person is also permitted and must be done between 45 days and the Saturday before Election Day.
WI	All votes sent via mail must be delivered by 8 p.m. on Election Day; it is recommended that voters send in their ballots one week before Election Day to arrive in time. Additionally, in-person absentee voting is available at an individual's local municipal clerk offices.

As of July 22, 2020.

Source: State government websites

is back to pre-COVID levels, suggesting the effect of the recessionary environment on sentiment may not be as extreme as other data may suggest (Exhibit 4). Consumer confidence is another important data point. For context, the Conference Board Consumer Confidence Index series declined from 132.6 in February to 85.7 in April; it has since increased to 98.1. This was a much faster decline than what we have seen in prior recessions, though the peak-to-trough difference in absolute terms is not the largest of recession time periods.

Exhibit 4: Real Disposable Personal Income Per Capita



As of May 31, 2020.
Source: U.S. Bureau of Economic Analysis

Question: Blue wave to sink the market or a prelude to calmer seas?
Answer: Blue wave is a realistic scenario; extreme bearish or bullish views are likely overstated.

There has been an increased focus on a "blue wave" scenario in which Biden would win the presidency and Democrats win the Senate and maintain control of the House. A major policy change is likely to occur with one-party rule, as was the case in the first two years of President Trump's tenure. Democrats need four additional seats to have a majority but only three if Biden is elected president as his vice president would be the swing vote in a 50-50 split Senate. We would highlight five Senate races worth monitoring closely: Alabama, Michigan, Colorado, Texas, and Maine. Republicans appear most vulnerable in Colorado, and historic Republican strongholds of Texas and Maine are now in play for Democrats. Meanwhile, Republicans may be able to reclaim their seat in Alabama, which Democrats won in a special election in 2017. With their candidate polling well thus far, Republicans may also have a shot at winning in Michigan, a state that President Trump won. A scenario in which Biden wins by a large margin could very well see a blue wave, but a still-split Congress also appears a possibility in a narrow win for Biden scenario, based on what we know right now.

The most pressing issue from a market perspective in a blue wave is the likely tax increases. We address the implications of Biden's stated plan regarding income taxes in the box on page 7. The market would likely be more fixated on corporate tax changes; Biden's tax proposal includes an increase in the corporate tax rate from 21% to 28%, a new minimum 15% tax on book income for companies with over $100 million in revenue, and also a doubling of the global minimum tax on offshore profits from 10.5% to 21%. Given that corporate tax cuts at the end of 2017 drove earnings for U.S. companies, there is a potential for markets to move lower if such a change were enacted.

While we do not discount negative market sentiment around potential tax increases, we point out that the ongoing COVID-19 shock may delay or soften the increases that Biden would actually propose when in office. Further, it is likely that tax increases would come alongside an infrastructure spending package, which could partially offset a perceived economic drag from the tax side. While infrastructure typically affects the economy and sentiment with a longer lag than taxes do, to the extent that the infrastructure package is "green-" and tech-oriented, it could have a quicker impact than historically has been the case.

Another important policy angle for markets is trade and tariffs. And regardless of the long-term implications one way or the other, the uncertainty around trade and tariff policies has increased market volatility. This was most evident in May and August 2019. Biden has taken a tough tone on China of late, so it is not clear that there would be a meaningful change in the current approach. One could argue that he may have a more predictable style and approach — for example, not using tariffs for non-economic goals as President Trump has occasionally done. Biden is also likely to build a closer relationship with Europe and work in a multilateral manner with other countries to pressure China on what is perceived to be abuses of the global trade system. There may be some market positive sentiment attached to that, potentially mitigating some of the negative of the hit from higher taxes.

Question: Does Biden's selection of a vice president nominee matter to the election and markets?
Answer: Historically, the vice presidential nominee has not changed the course of a race; there may be greater scrutiny of the nominee in 2020.

Former Vice President Biden is expected to announce his vice presidential nominee in the coming weeks; given that he has stated he will choose a woman as a running mate, speculators have narrowed on a small group of contenders with Kamala Harris and Susan Rice leading the field on betting sites. A *Wall Street Journal* poll conducted in 2016 found that historically, the majority of respondents said the vice presidential choice had no impact on their voting decision. Also, according to a study by FiveThirtyEight, the vice presidential nominee's impact on his or her home state has been just two or three percentage points on average. This year, perceived readiness for the presidency may be a greater factor than usual given that a President Biden would be 78 on Inauguration Day. Given that Biden is thought to be among the more moderate of the original contenders on the Democratic side, there may also be greater scrutiny regarding the political ideology of the choice, with a more left-leaning candidate likely driving greater turnout in some states, but potentially creating a challenge in swing states. We note that voters would likely keep any scrutiny over the vice presidential nominee in context with the setup on the Republican side: President Trump would be 74 on Inauguration Day if reelected, and Vice President Pence is generally viewed to be right-leaning within the spectrum of Republicans.

Biden's Individual Tax Policy

Joe Biden has pledged that taxes will not increase for anyone making less than $400,000 per year. A more progressive tax code would apply beyond this level, with tax increases falling predominately on the top 1% of earners. In repealing elements of President Trump's 2017 tax reform, Biden's tax plan would restore the top individual rate to 39.6% from 37% and limit the benefit from itemized deductions and credits to 28% for the top tax bracket. Additionally, long-term capital gains and qualified dividends would be taxed as ordinary income for those earning more than $1 million; carried interest would also be taxed as ordinary income. For income over $400,000, the plan also eliminates the income cap on Social Security taxes and phases out the qualified business income deduction (Section 199A). Finally, Biden's tax proposal removes the step-up in basis for inherited assets.

Unlike some of the more progressive members of the Democratic Party, Joe Biden has not called for a direct wealth tax to be imposed based upon net worth. However, there has been some debate among Democrats regarding an unrealized capital gains tax (taxing unrealized capital gains even if assets aren't sold) as an alternative to a wealth tax. An unrealized capital gains tax poses many logistical issues and has several market implications. Logistically, it is unclear how venture capital and real estate would be valued or how taxes would be paid. In terms of market implications, it is possible that M&A activity could increase and that investors would look to sell holdings to reset their gains in late 2020 ahead of potential policy changes. Furthermore, it is possible that an unrealized capital gains tax would remove the disincentive to sell stocks with gains, thereby eliminating a natural stabilizer for publically traded stocks. While the general election is still months away, Bessemer's tax and estate team is actively evaluating candidate proposals and planning for potential actions that may be appropriate for clients.

Concluding Thoughts

As the political landscape evolves over the coming months, we look forward to sharing updates on our views within our weekly updates and other publications. We encourage clients to participate in our mid-August webcast, which will cover thoughts on tax implications of different scenarios as well as expectations for financial markets. Thank you for your continued trust in us, and please reach out to your advisor with any questions.

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