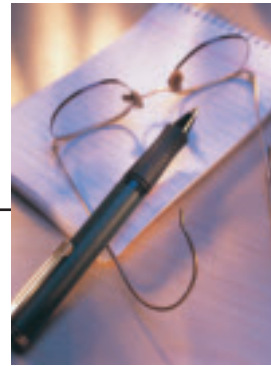


HAPPY NEW YEAR

The persistence and causes of the January effect.

FIELD NOTES

BY GEORGE ATHANASSAKOS



True or false. Compared to the rest of the year, January is the month with the strongest stock market performance. The answer, called the “January effect,” depends on three factors. The first is the time period being considered when calculating average monthly returns of a given portfolio of stocks. Second, as the January effect is a portfolio rather than a specific stock effect, it depends on the capitalization of the stocks in the portfolio. Third, not every January witnesses a strong stock market performance. Instead, the January effect is an average one. Let’s examine these points in detail.

The Figures accompanying this article show the returns of two portfolios over three different periods. The first is tilted towards larger stocks (Figure 1) and the other is tilted to smaller stocks (Figure 2). Both portfolios are from the Canadian Financial Markets Research Centre at the University of Western Ontario for the period 1957 to 2003 and for sub-periods 1957 to 1980 and 1981 to 2003. It is obvious from these Figures that January is the strongest month for both small and large cap stocks only in the 1957 to 1980 sub-period. For 1957 to 2003 and 1981 to 2003, January is the strongest month only for small cap stocks, with December being the strongest month for large cap stocks.

However, even for the smaller cap stocks, a January effect does not happen every year. Over the 47 years between 1957 and 2003, there were 37 positive Januaries for small cap stocks and 10 negative Januaries. The average monthly return of positive Januaries was 7.67%, and for negative Januaries, -3.42%. Hence, we can see that the positive Januaries tend to be very strong and the negative Januaries are very weak.

While it is true that the January strength has been diluted somewhat in recent years, spreading to November and December, a strong January is still present. Moreover, this spreading out of the January effect has given rise to an even stronger pattern, with stock markets realizing almost all of their annual return over six months, from November to April. Between May and October, the average stock market return is close to zero, irrespective of the market cap of the portfolio. This has given rise to the expression “Sell in May and go away,” which is another very strong and predictable pattern.

FIGURE 1
AVERAGE MONTHLY RETURNS FOR LARGE CAP PORTFOLIO, 1957-2003 AND SUB-PERIODS

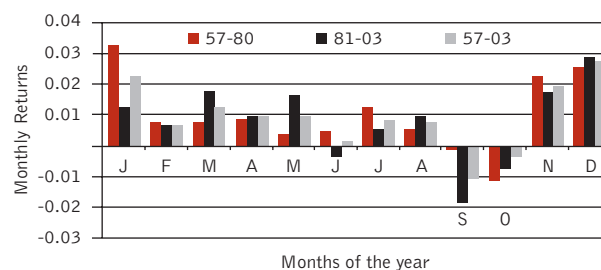
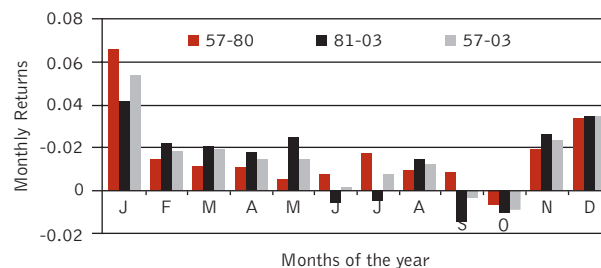


FIGURE 2
AVERAGE MONTHLY RETURNS FOR SMALL CAP PORTFOLIO, 1957-2003 AND SUB-PERIODS



George Athanassakos is professor of Finance and the Ben Graham Chair in Value Investing, Richard Ivey School of Business, The University of Western Ontario.

Window-dressing and remuneration-motivated portfolio rebalancing are exacerbated by herding.

FIELD NOTES

FOLLOWING THE HERD

But why do such predictable patterns exist and persist? The cause of these patterns rests on individual investor biases in investment behaviour and on conflicts of interest portfolio managers have when they manage clients' money. The investment decision-making process is key. While we like to say that institutions make investments, institutions do not actually make investment decisions—individuals working for institutions make them. They have their own psychologies and their own interests and agendas. This principal-agent relationship induces portfolio managers to act on their own behalf, trying to maximize their own wealth, as opposed to that of their clients.

Portfolio managers exhibit a human trait—herd mentality. According to Bruce Greenwald of Columbia University, they feel safe when their portfolios look like everyone else's because no one is likely to lose his or her job due to average performance or for holding the same securities as the rest of the peer group. Herding becomes more pronounced toward the end of the year when portfolio managers window-dress to spruce up their portfolios, selling stocks that have fallen in price and buying stocks and other securities, such as government bonds that have done well and in the public eye. At the same time, portfolio managers lock in good performance by selling risky stocks they bought at the beginning of the year and moving to lower-risk securities in order to secure their Christmas bonus.

Window-dressing and remuneration-motivated portfolio rebalancing are exacerbated by herding and affect the prices and returns of financial securities throughout the year in a predictable way. On average, risky stocks and high-risk bonds are bid up or down at the beginning of the year or towards year-end. At the same time, low-risk stocks and risk-free bonds are bid up or down towards year-end or the beginning of the year. Notably, Government of Canada bonds tend to exhibit weakness in the first half of the year and strength in the second half of the year.

The pattern repeats annually, mimicking window dressing and/or the annual performance evaluation cycle of portfolio managers.

However, portfolio managers would not invest in risky securities indiscriminately, whether the year was a bull or bear market or whether it was a recovery or a recessionary year. Portfolio managers invest in risky securities when the year ahead is expected to be good and withhold their investment from such securities if the year ahead is forecast to be adverse. My research has shown that the strength in risky securities at the beginning of the year is not a sure thing, but largely depends on what institutional investors think of the year ahead. This is also consistent with the popular expression, "as January goes, so goes the year." If institutional investors are, on average, right when they expect a recession or bear market in the year ahead, and they divest risky securities at the beginning of the year when portfolios are rebalanced, it is only natural to also expect risky securities to experience weakness in January and in the months of the year that follow and, as a result, for the year as a whole. This should not be the case for risk-free securities. That is why not every January is a positive one and why the month tends to be really strong when things turn out well, and really bad when things go badly.

Such seasonal behaviour is difficult for the markets to fully eliminate, for two reasons. First, it is related to window dressing or remuneration-motivated turn-of-the-year portfolio rebalancing by professional portfolio managers who pursue their own interest year in and year out. Second, seasonality is not consistently observed every year. Unless we have a unified theory to help us anticipate seasonal behaviour on a regular basis, market participants can't fully arbitrage the seasonal behaviour of financial securities. This is particularly true since professional portfolio managers' survival is based on short-term performance metrics. ■