**The January Effect: Not always, but often**

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*The Globe and Mail*
February 1, 2006

Does the so-called January Effect exist?

The herd mentality of portfolio managers can conspire to boost the performance of stocks during the first month of the year and January can turn in the best performance, depending on a few qualifications. First, it depends on the time period. Second, the January Effect refers to a portfolio of stocks, so the capitalization of the stocks matters. Third, not every January witnesses a strong stock market performance, so the January Effect is more of an average-over-time effect.

Figures from the Canadian Financial Markets Research Centre at the University of Western Ontario show that January is strong for both small- and large-cap stocks only for the 1957-1980 period. For 1957-2003, January is a strong month only for small-cap stocks, while December is the strongest month for large caps.

The S&P/TSX composite index rose 6 per cent in January, its best monthly performance since November, 2001. In the United States, the S&P 500 index climbed 2.5 per cent last month, its best January gain since 2001, a trend that may bode well for the rest of the year. The blue-chip Dow Jones industrial average rose 1.4 per cent, for its best January since 1999.

However, even for small caps, January isn't always rosy. During the 47 years from 1957 to 2003, there were 37 positive Januarys for small caps and 10 negative Januarys. The average monthly return of positive Januarys was 7.67 per cent. For negative Januarys, the average loss was 3.42 per cent.

These are the facts. A more interesting question is why such predictable patterns exist and why do they 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.

Portfolio managers run in herds, a human trait. According to Columbia University's Bruce Greenwald, they are safe when their portfolios look very much like those of everyone else who invests with the same mandate. Portfolio managers don't lose their jobs because of average performance or if they hold 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 by selling stocks that are obscure and have fallen in price and buying stocks (or government bonds) that have done well and are visible and in the public eye.

At the same time, portfolio managers lock in good performance by selling risky stocks and moving into lower-risk stocks or risk-free bonds to improve their Christmas bonuses. Window dressing and remuneration-motivated portfolio rebalancing, exacerbated by herding, affects prices and returns of financial securities throughout the year in a predictable way. On average, risky stocks and high-risk bonds are bid up at the beginning of the year and down toward the year's end, whereas low-risk stocks and risk-free bonds exhibit the opposite.

However, portfolio managers do not invest in risky securities indiscriminately. My research has shown that portfolio managers invest in risky securities when the year ahead is expected to be a good one and are more cautious if the year ahead is forecast to be adverse. This is consistent with the expression, “As January goes, so goes the year.”

If institutional investors are right, on average, when they expect a tough year and divest from risky securities at the beginning of the year, it is only natural to expect risky securities to experience weakness in January, the months that follow and, as a result, the year as a whole. That is why not every January is a positive one. And that is why January tends to be quite strong when things turn out well and quite bad when the year doesn't go well.

Such seasonal behaviour is difficult for the markets to fully eliminate for two reasons. First, it is related to end-of-the-year portfolio rebalancing by professional portfolio managers who herd and pursue their own interests 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 consistent basis, market participants can not fully arbitrage the seasonality of financial securities. This is particularly true since the survival of professional portfolio managers is based on short-term performance metrics.

While it is true that the January strength has been diluted a bit in recent years and spread to December and, to a lesser degree, November, a strong January still persists. This spreading out of the January effect has given rise to an even stronger pattern: Stock markets realize almost all their annual return over the six months from November to April.