OPINION

Why this is the year to 'sell in May and go away'

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Say you are a portfolio manager and January to April you are up 15%-20% (not an unrealistic number for many), what will you do to safeguard your Christmas bonus in light of plenty of sings of market exuberance?

Even value investors who invest bottom up in recent years have started to worry top down, and there is a lot of top down worries at the moment, some of which belong to the realm of "know what I do not know" and others to "do not know what I do not know."

Let me refer to some signs of market exuberance as enumerated in Market Ethos by Richardson Wealth.

First, the AAII Bull/Bear survey indicates that the 'number of bullish investors outnumber the bearish investors by 32 points – it is historically a contrarian indicator and when the spread exceeds 20 points it is a reason for concern.

Second, the VIX index is trading at record low levels. Given that the index is many times referred to as "the fear gauge," it indicates that fear of market correction is at a very low level.

Cash balances of professional money managers is well below historical levels.

The ratio of insider sales to buys indicates that there are 143 sales for every buy by insiders.

Buying stocks on margin is skyrocketing. Margin debt has recently experienced its greatest increase in the last 20 years.

Inflows on ETFs and US equity funds have exploded.

Individual investors are investing in greater numbers in the market in recent months. And evidence indicates that retail investors are notoriously bad market timers. They are exuberant at the market peaks and panic stricken at market bottoms.

And all of these on top of: the rise of SPACs, IPOs, leveraged loans, mergers taking place at elevated multiples, rising global debt around the world, and valuation metrics that point to a richly valued market. For example, equity value to GDP stands at the highest level since the 1950s with only exception of the 1999-2000 tech bubble, while Wilshire 5000 to GDP has reached an all-time high.

In light of the aforementioned risks, my crystal ball says that portfolio managers will be heavy sellers of equities in May leading once more to the pattern consistent with the adage "sell in May and go away." And there is plenty of academic research that supports its existence. The phenomenon is still alive (even though it has weakened from historical levels) and provides profitable investment opportunities. One needs to understand its powerful drivers before casting a negative opinion on this phenomenon – and I have seen a lot of recent commentary in the media ridiculing the belief of its existence. This seasonal pattern rests on human psychology and the conflicts of interest of professional portfolio managers

Professional portfolio managers' own agendas and their efforts to maximize their own benefits lead them to rebalance portfolios and window dress in a predictable way throughout the year.

The high average returns on risky securities in the beginning of the year are caused by systematic shifts in the portfolio holdings of professional portfolio managers who rebalance their portfolios to affect performance-based remuneration. Institutional investors are, on average, net buyers of risky securities early on in the year when they are motivated to include less-known, high-risk securities in their portfolios and are trying to outperform benchmarks.

Later on in the year, portfolio managers lock in returns (and their Christmas bonus) by divesting from lesser-known, risky stocks and replace them with well-known and less risky stocks or risk-free securities, such as government bonds. Such behaviour affects prices and security returns in a predictable way. Risky stocks and high-risk bonds are, on average, bid up early on in the year and down later on in the year, whereas low-risk stocks and risk-free bonds exhibit the opposite behavior - down early in the year and up later.

As arbitraging is taking place by those investors not bound by the restrictions or conflicts portfolio managers are facing, the pressure on stock and government bond prices is spread over a few months, giving rise to stock market relative strength in November to April and relative weakness in the May-to-October period and the opposite effect for risk-free bonds.

Consistent with this seasonal pattern, my research has shown that the strongest quarter of the year for fund flows into stocks is the first quarter (January-March), while for Government of Canada bonds, the strongest quarter of the year is the fourth quarter (October-December).

Such seasonal behavior in security returns is difficult for the markets to fully eliminate for two reasons.

First, it is related to window dressing and remuneration-motivated 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 can anticipate seasonal behavior on a consistent basis, market participants cannot fully arbitrage the seasonal behavior of financial securities.

All this leads to my belief that we may have a strong “sell in May and go away effect” this year.

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