OPINION

Why Nasdaq stocks saw a supercharged 'January effect' this year

GEORGE ATHANASSAKOS >
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED YESTERDAY

FOR SUBSCRIBERS

Portfolio managers exhibit herd mentality. They are safe when their portfolios look pretty much like those of everyone who invests with the same mandate, as no one loses his or her job because of average performance or holding the same securities as the rest of the peer group.

Herding becomes more pronounced towards 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 up stocks 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 (which they bought at the beginning of the year) and moving to lower-risk stocks in hopes of a better Christmas bonus.

Window-dressing and remuneration-motivated portfolio rebalancing, exacerbated by herding, affects prices and returns of financial securities throughout the year in a predictable way. Risky stocks are bid up (safe stocks are bid down) at the beginning of the year, whereas low-risk stocks are bid up (risky stocks are bid down) toward year end. The pattern repeats annually.

Such seasonal behaviour is difficult for the markets to fully eliminate for two reasons. First, it is related to window-dressing and/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 such

seasonal behaviour on a consistent basis, market participants cannot fully arbitrage the seasonal behaviour of financial securities.

Historically, it has been remuneration-motivated portfolio rebalancing that mostly affected fourth-quarter and January stock returns. In the last two months of 2022 and the first month of 2023, however, such behaviour has been reinforced by extremely active window-dressing by professionals and further augmented by strong tax-loss selling by individual investors. Tax-loss selling is a strategy that involves selling losing stocks and using the capital loss to offset any capital gains incurred in the tax year.

Window-dressing by portfolio managers and tax-loss selling by individual investors had a great impact on this year's January stock returns, particularly those of Nasdaq returns, which rose by over 11 per cent in January, one of the strongest January returns on record.

Table 1 can help us understand what happened over the past few months. It shows the return and trading volume for shares of the worst-performing stocks (those with the highest incentive for tax-loss selling) in S&P 500 and Nasdaq for three periods: March to October, 2022 (normal trading period), November to December, 2022 (tax-loss selling period), and January, 2023. Both indexes experienced sharp losses between March and October, especially Nasdaq. Average (daily) volume-to-shares-outstanding were 1.6 per cent for S&P 500 and 10.5 per cent for Nasdaq.

The severe stock market losses over the March-October period provided a powerful incentive to professional portfolio managers and individual investors to employ a tax-loss selling strategy over November-December. As a result, both indexes experienced further losses in the period with an uptick in volume-to-shares-outstanding, up 8.75 per cent to 1.7 per cent for S&P 500 and up 64.8 per cent to 17.3 per cent for Nasdaq, denoting markedly increased trading vs. earlier months of the year (i.e., the normal trading period).

In January, as recession fears subsided, portfolio managers started to raise the risk level of their portfolios by going aggressively after riskier stocks and less so after

lower-risk stocks. This trading activity was reinforced by those professionals and investors who went back to the market to buy back the stocks they had sold for tax-loss purposes in the previous months. This led to a supercharged "January effect," particularly for Nasdaq stocks that experienced a sharp increase in prices (up 50.2 per cent in January) and volume (up 150 per cent in January compared with March-to-October and up 52 per cent compared with November-to-December volume-to-shares). While the S&P 500 volume-to-shares did not change much, as it includes larger and safer stocks, Nasdaq stock prices and volume exploded.

It is instructive to compare the performance and volume-to-shares of the riskier Nasdaq stocks with those of three safe S&P 500 stocks, namely Johnson & Johnson, Procter & Gamble and Colgate Palmolive. In Table 2 we see that the January volume-to-shares of these stocks did not change much from March to October given that there was not much of an incentive to use a tax-loss selling strategy in this case. These stocks outperformed the broader market in November-December and underperformed it in January, consistent with portfolio rebalancing.

Table 1: Jan. 2023 trading volume and performance of worst-performing S&P 500 and Nasdaq stocks in 2022

WORST 5% PERFORMING STOCKS	RETURN MAR-OCT 2022	VOL/SHARES MARCH-OCT. 2022	RETURN NOV-DEC 2022	VOL/SHARES NOV.-DEC. 2022	RETURN JAN 2023
S&P 500	-38.80%	1.60%	-10.2%	1.74%	31.3%
Nasdaq	-83%	10.50%	-10.8%	17.30%	50.2%

Table 2: Jan. 2023 trading volume and performance of three safe S&P 500 stocks vs. 2022

THREE SAFE S&P 500 STOCKS	RETURN MARCH-OCT. 2022	VOL/SHARES MARCH-OCT. 2022	RETURN NOV.-DEC. 2022	VOL/SHARES NOV.-DEC. 2022	RETURN JAN 2023
Colgate -Palmolive Co.	-1.1%	0.59%	4.6%	0.41%	-5.8%
Johnson and Johnson	7.5%	0.28%	3.1%	0.24%	-6.3%
Procter & Gamble Co.	-10.5%	0.30%	7.9%	0.26%	-5.6%

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, University of Western Ontario.

Be smart with your money. Get the latest investing insights delivered right to your inbox three times a week, with the Globe Investor newsletter. Sign up today.

Sign up for the Globe Investor Newsletter

Money-making ideas, insight and market analysis from The Globe's investment experts and journalists.

SIGN UP