The January Barometer: Fact or Myth

Every year around year-end the financial media reports on the so-called January barometer. According to Wall Street lore, stock market returns during the month of January portend the returns for the year. If stock market returns are positive during the month of January, investors should expect that returns for the year will also be positive. If January returns are etched in red ink, look for the stock market to experience losses for the year.

At first blush, there appears to be some truth in this long standing adage. During the last seventy years (1941-2010), for example, January's return has correctly predicted the direction of the S&P 500 Index over the entire year 55 times or 78.6 percent of the time. However, comparing the stock market's annual return with the return in the month of January introduces a significant bias. That's because January's return is used in the calculation of the year's return. For example, suppose the return during January amounts to 10 percent. During the remainder of the year, an 11-month return greater than minus 11 percent would produce a positive return year and a correct January prediction. Similarly, a significant January loss provides a significant head start to a losing market year.

To eliminate this apparent bias and gauge the predictive power of the January barometer, one should compare January's return to the stock market's return during the subsequent 11 months. When I corrected for this glaring arithmetic error, I found that January's return predicted the direction of the market during 50 of the 70 years studied, which resulted in an accuracy rate of 71.4 percent.

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Of course, predictive accuracy in excess of 70 percent is still impressive. However, you shouldn't be fooled by this statistic. The stock market spends a lot of time heading toward higher ground. Bull markets tend to be long while bear markets tend to be short, albeit steep. For example during the last 70 years, the stock market posted positive returns during 52 years, or 74.3 percent of the time. Furthermore, if on January 31, you predicted that the stock market would rise during the next 11 months, you would have been correct 54 times or 77.1 percent of the time since 1941. In other words, making a prediction on January 31 that the stock market will rise during the remainder of the year provides a greater accuracy rate than the January barometer (77.1 percent versus 71.4 percent) based on my calculations. My conclusion: the January barometer is more myth than fact!

That being said, January is still a curious month for stock market returns. During the month of January, small capitalization stocks not only have produced abnormally high returns, their returns

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top those of large capitalization stocks a significant number of times. In other words, it has historically paid well to be invested in small-cap stocks during the month of January.

Here are a few statistics. During the last 70 years, small firm stocks produced a 4.89 percent average monthly return during the month of January. Furthermore, January proved to be an up month for small-cap stocks 54 times or 77.1 percent of the time. During the last 70 years, small-cap stocks posted double-digit percentage returns during 13 Januaries while posting a double digit loss only once (-11.9 percent in 2009). In addition, small-cap stock returns exceeded those of large- cap stocks during 55 of the last 70 Januaries or 78.6 percent of the time.

Academics refer to the abnormal return behavior of small-cap stocks during the month of January as the

"January effect." There is no definitive reason why small-cap stocks have acted abnormally during the month of January. However, it is hypothesized that the excess returns have been due to year-end tax loss selling by taxpaying investors. As year-end approaches, taxpaying investors dump losing stock positions to offset gains realized during the year. This selling activity puts downward pressure on small-cap stocks that are much less liquid than are large-cap stocks. When this selling abates at year-end, the downward pressure on small-cap stock prices is arrested and small-cap share prices have tended to rebound during the first few weeks of the new year. Because of their high degree of liquidity, large-cap stocks do not experience the same degree of downward price pressure exerted by a marginal increase in tax loss sales. As a result, I believe they exhibit a much lower rebound effect than do small-cap stocks at the beginning of the year.

I am not suggesting that investors use the January effect to trade small-cap stocks (or mutual funds that invest in them). However, investors can potentially use the January effect to their advantage. In my opinion, investors who plan to add to their small-cap portfolios during the upcoming year should make those purchases in late December of the preceding year. Investors who wish to trim their holdings of small-cap stocks may want to postpone any year-end sales until late January. Although these activities do not guarantee higher returns, I believe these actions may potentially tilt the odds in an investor's favor based on this historical research. No one can predict the future with certainty. However, tilting the odds of investment success in one's favor can potentially give investors an edge over those who choose not to do so.

Source: Ibbotson & Associates, *Stocks, Bonds, Bills and Inflation Yearbook, 2010*

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Small company stocks are defined as the bottom quintile of securities ranked by market capitalization from 1926-2009. Large company stocks are represented by the S&P 500 index. The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

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