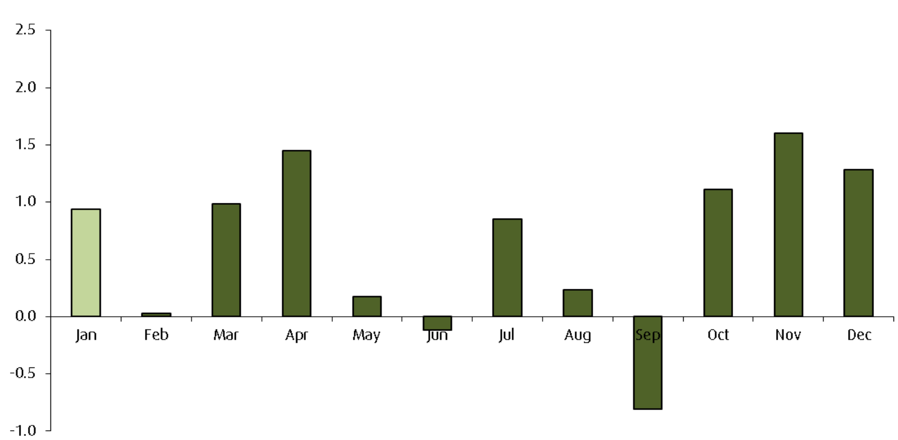
The January Effect

"I've never been able to **predict** accurately. I don't make money **predicting** accurately. We just tend to get into good businesses and stay there." – The Late Charlie Munger

Welcome to a New Year full of excitement, improbability and, most importantly, opportunity. If this post reaches those who are results driven, it is time to cement renewed goals and pave paths to achieve those said aspirations. Whether it be a personal or professional goal, it is incumbent on us all to reset the clock with a level of consistency and discipline. **Although fueled on investor emotion, the financial markets do not have the luxury to reset January 1. They continue to operate as if it is another day.**

There is, however, an interesting historical trend that has garnered a lot of active investors attention in the past, known as the January Effect. This effect is perceived as a seasonal increase in prices during the first month of the new calendar year. Comparatively speaking, it is often speculative in nature to assume a single month will provide significant upside when positioned against other months throughout the year. However, empirical evidence posits this pattern as steady in its hypothesis of January being a positive performer. The illustration below depicts S&P 500 average monthly returns dating back to 1960. The S&P 500 is known as a barometer for large cap companies in the United States and has significant multinational presence. The historical feedback would coincide with varying market cycles, leading to two seminal themes; markets naturally start and end the year in positive terrain after a notorious summertime lull.

S&P 500 Average Return by Month
(1960-present)



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I will note, however, January's results were slightly underwhelming as it charted in the middle of the pack over a 60-year period of condensed monthly return data. Does this mean smaller more volatile companies are more impacted by this occurrence? One would assume that with most companies having an average lifespan of over 20 years on the S&P500, the corporate longevity is not in question and these established businesses are less actively traded on a seasonal or monthly basis. The subsequent contention would then be whether the positive returns are a trend or purely a random walk?

Rationale behind this Phenomenon

Although disputable, there are three main proponents behind this historical theory:

1) **Tax loss harvesting:** tax loss selling is considered the timely selling of individual securities at a loss to offset the amount of capital gains taxes owed from more profitable assets. An annual tax loss campaign is a judicious practicality that most wealth managers incorporate around year end to offset taxes realized through trading activity. More established large cap stocks tend to be mature companies by nature, insulating them from stark volatility of the economic cycle. Whereas small cap stocks are younger companies with higher growth profiles than their large cap counterparts. With this, comes increased susceptibility to volatility due to more fragile financials and fundamentals. Remaining objective to this strategy, most positions that will be sold at a loss in any given year tend to be smaller cap holdings that experience the ebbs and flows of the economic cycle. The proceeds of sale would then be redeployed back to their weights in their respective investment model after 30 days. Hence, the run-up in January.

2) Despite the United States continued expansion through a multitude of economic headwinds, it has largely been considered a leaner year in most industries due to the challenging macroeconomic backdrop. Corporate America (and Canada) will still allocate capital on their ("weaker") balance sheets to reward high performers with **annualized bonuses**. This is a concerted trend throughout most industries in profitable years that can be structured towards company stock options, retirement accounts, or as cash[2]. The influx in available cash allows retail investors to participate in wealth building activities at the beginning of each year. Simple demand/supply metrics would impose that the more inflows the financial markets gathers at any capacity will lead to increased initial returns.

3) The final rationale is rather dated, as due diligence and transparency obligations have resulted in the demise of faulty trading strategies. Fund managers are now vulnerable to greater scrutiny and must succumb to more ethical reporting standards. In the 70's when the January effect was generally a predetermined outcome more so than a misleading notion, professionals managing wealth at any capacity had the ability to **"window dress"** their portfolios prior to year end[3]. Predominantly institutional managers had the discretion to sell losers at a larger scale, leading to a survivorship bias in their annual reporting with only winning positions highlighted. They would argue that portfolio returns can be noisy and manager philosophy and implementation can be more credibly analyzed by the holdings reported. After managers delivered reporting without conflict, sidelined proceeds were either redeployed to losing

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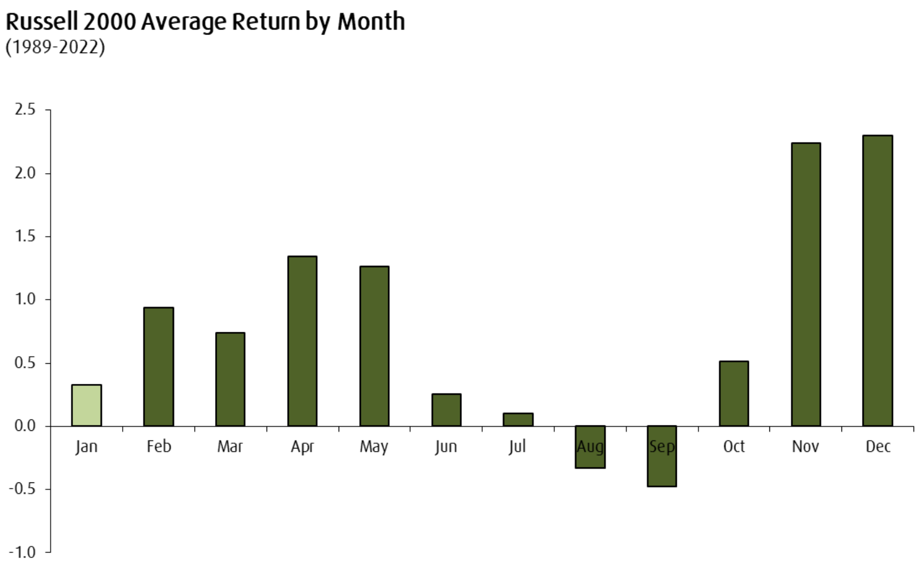
positions or rebalanced to other allocations. With more regulatory standards at play, this tactic is quite literally impossible for publicly traded developed markets. It does, however, demonstrate that gaming the system was prevalent before unified regulation challenged deceitful trading.

Is this Seasonal Pattern Prominent?

This seasonal pattern was an assertion made in 1942 by investment banker Sidney B. Wachtel. From 1904-1974 the New York Stock Exchange recorded an average market return of 3.48% in January compared with a monthly return of .42 percent during the remaining 11 months of the year[4]. This was reflected through an equal weighted index which gives greater influence to smaller capitalized companies relative to a market cap index where larger players dominate (akin to the "magnificent 7 tech stocks" this year). To observe if the increase in valuations was more dominant in smaller cap positions in the latter decades of the 90's and 2000's, our economics team graphed the historical monthly returns of the Russell 2000 index. The Russell 2000 Index is classically referred to as the bellwether of the US economy because of its focus on smaller companies in the US market[5]. **As seen below, this graph opposes the entire theory in its entirety. A visual application of January returns shows little significance in favour of the "effect". More recently, a Goldman Sachs analysis completed over the past 5 years noted that the January Effect has faded in significance since the new millennium.**



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What does this mean from an Investors Lens?

In January 2022 we saw returns of -5.3% in the S&P 500, followed by +6.2% the following January 2023. To predict with certainty what will happen month by month is purely speculative conjecture. Additionally, it is that time of the year where investment professionals prognosticate their varying predictions with regard to how equity markets will react over the next 12 months. Such endeavours rarely translate to the actual outcomes due to exogenous surprises. The average target of 22

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forecasters surveyed by Bloomberg on December 20th, 2022 was that the S&P 500 would close December 2023 at 4078 (albeit, a modest and below average 6.2% gain)[7]. As of December 29th, 2023 close the S&P 500 is valued at 4770 which is equivalent to a ~24% price return. This end of the year result is a rather good story following the universal negative headlines pertaining to crypto market collapses (and rejuvenation), continued central bank hikes, Silicon Valley and global banking failures, Big Tech layoffs, unresolved geopolitical disputes and global real estate woes. The exercise of anticipating the year-end (or month-end) value of major global indices with current economic numbers, although enticing, can lead to incongruent behaviour by investors. The markets are a function of buying and selling based on sentiment in the short term. The pervasive nature of how practitioners deviate in their calculated predictions can cause conflicting investor behaviour if the right coaching is not in place.

Predictions are based on "knowns" and "unknowns". The central banks next moves and their transition to "dovish" behaviour to rate normalcy is considered a known. An unknown positive, or negative, is quite literally impossible to prophesize. Analysts can create downside scenarios based on event risks, but even the most highly educated can miss the mark. What we do know with certainty, is a well constructed and disciplined portfolio displays long-term positive results regardless of what January or any other month brings to the table.

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1) 2023 Bull Market Awards (bmo.com)
2) The January Effect: Fact Or Fiction? (forbes.com)
3) January Effect | Overview, Theoretical Explanations, & Criticisms (financestrategists.com)
4) Haug and Hirschey, M. (2005). *The January Effect*. University of Kansas, pp. 2
5) Russell 2000 Index: definition, constituents and returns (cityindex.com)
6) The 'January effect' for stock markets is fading - Goldman | Reuters
7) 2023 Bull Market Awards (bmo.com)
8) 2023: Another miserable year for market forecasters « Mathematical Investor (mathinvestor.org)

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