Understanding the History of the January Effect

Can the monthly performance for January predict how 2023 will perform?

The January Effect is a pattern exhibited by stocks in the last few trading days of December and the first few weeks of January. During this period, particularly starting in January, the theory is that stocks tend to rise.

In simple terms, the January Effect is a consequence of:

- Tax-loss selling, in which investors sell stocks that lost money at the end of December in order to take losses as tax deductions and
- Mutual funds' window-dressing, which is exactly as it sounds.

Because so many of these stocks were sold in late December, they will be – in theory – available at a discount in early January. Another purported cause of the January Effect is the payment of year-end employee bonuses (less likely in 2022), which employees invest in the stock market. As a result, investors with more money end up buying cheaper stocks, making the market more active and driving up prices.

Myth, Legend or Both?

The January Effect is not just a Wall Street myth as several prominent studies have confirmed its existence. One study of historical data from 1904 through 1974 discovered that the average return during January was five times larger than the average return for other months.

Another study by the investment firm Salomon Smith Barney (no longer in existence by the way) showed that small cap stocks (as represented by companies in the Russell 2000) outperformed large cap stocks (as represented by companies in the Russell 1000) by 0.8% in January, but lagged large caps for the rest of the year.

Further, consider this:

- From 1928 through 2022, the S&P 500 rose 62% of the time in January (59 times out of 95).
- Over the past 30 years, we saw 17 winning Januarys vs. 13 losing ones, or a 57-43% split.

Effect Becomes Less Effective

In recent years, the January Effect has become less pronounced. As a result, it is a less effective way for investors to take advantage of the market. Once investors, economists and traders spot, analyze, and confirm the existence of a trend, it tends to become less pronounced.

Investors "price in" the trend, adjusting their investment strategies to take trends (like the January Effect) into account. Another reason that the January Effect is less important is that many people now use tax-sheltered retirement plans, like IRAs and 401(k) plans. When investments are tax-sheltered, there is no special reason to sell a stock for the purpose of deducting stock losses.

Using January to Predict 2023

Many investors and analysts have tried to use the January Effect for predictive value. However, there are different questions about predictions.

Surprisingly, according to *Stock Trader's Almanac,* going back to 1950, that metric of January's monthly performance predicting the year has worked about 87% of the time.

But if you take out the years from 1950-1962, the January metric worked about as well as a monkey making a coin toss. From 1962 to 2022, a below-par January accurately predicts a bad year 53% of the time.

So, What Should You Do?

As these numbers show, the January Effect is simply not a very good predictor of annual stock market performance.

As a result, omens in January are unlikely to predict the entire year.