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Examining the 'January Effect'

VIEWPOINT

By **ERIC B. PARNELL**

Some investors are always on the prowl looking to capitalize on unusual stock market trends. One such anomaly is known as the "January Effect", which states that the stock market has historically posted a 4% return on average during the month of January versus a 1% return on average across all other months over the last 75 years. While this trend might seem like a slam-dunk approach, a closer look reveals that more work must be done to discover the real investment opportunity.

What has caused the January Effect? Historically, many investors have decided to sell stocks that are down before the end of the year for tax purposes. They used the realized losses as an offset against capital gains and income. Once the new tax year arrived in January, investors returned to the market to buy back the stocks that they sold.

An examination of recent market history reveals that the January Effect has all but vanished. A look at the last 50 years shows that January ranks fourth across all months with an average return of 1.3%. Over the last 10 years, January is only the sixth best returning month on average. And in the first five years of this decade, January has drifted into the bottom half of all months with an average return of -1%.

Several factors explain the disappearance of the January Effect. First, a large and growing number of investors now participate in retirement programs such as 401(k)s and IRAs where taxes are not an issue. Second, while the tax year for individual investors ends on December 31, the tax year for most mutual funds ends on October 31. With all of the money tied up in mutual funds, a big percentage of tax loss selling now also occurs in October. But lastly, and probably most

significantly, investors are good at anticipating trends. The January Effect is now widely known by investment professionals, so most of the gains are typically factored into the market by the time January rolls around. Higher yields, which would push mortgage rates higher as a result. And this might have a cooling effect on the currently hot housing market.

So where does the individual investor find potential opportunity? By standing back from the tree and taking a bigger view of the forest. A look back over the last fifteen years reveals that stocks in the last quarter of the year have performed significantly better than the remaining nine months of the year. Since 1990, stocks during the months of October, November and December have generated an average return of nearly 6.8% versus less than 3.4% for the rest of the year. This gap has only widened in more recent history. Since 2000, for example, stocks have registered a 6.1% average *gain* during October, November and December period versus a 6.8% average *loss* during the other nine months of the year. So for those looking for a new market trend, the "Fourth Quarter Effect" has surfaced as a potential candidate.

But don't be mistaken and take this new "effect" at face value. Investment professionals are undoubtedly positioning for this anomaly in the future if they haven't already in the past. For example, the market rose nearly 2% from September 21 to September 30 of this year, as many investment professionals moved to anticipate the recent trend for a fourth quarter rally. As a result, the more ideal strategy is not necessarily to position for today's "effect", but instead to discover tomorrow's "effect" ahead of the group. That, after all, is where the real opportunity lies in the market.

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