# January Effect

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## What is the January Effect

The January effect is a seasonal increase in stock prices during the month of January. Analysts generally attribute this rally to an increase in buying, which follows the drop in price that typically happens in December when investors, engaging in tax-loss harvesting to offset realized capital gains, prompt a sell-off. Another possible explanation is that investors use year-end cash bonuses to purchase investments the following month.

## BREAKING DOWN January Effect

The January effect is a hypothesis, and like all calendar-related effects, suggests that the markets as a whole are inefficient, as efficient markets would naturally make this effect non-existent. The January effect seems to affect small caps more than mid or large caps because they are less liquid.

Since the beginning of the 20th century, the data suggests that these asset classes have outperformed the overall market in January, especially toward the middle of the month. Investment banker Sidney Wachtel first noticed this effect in 1942. This historical trend, however, has been less pronounced in recent years because the markets seem to have adjusted for it.

Another reason analysts consider the January effect less important as of 2018 is that more people are using tax-sheltered retirement plans and therefore have no reason to sell at the end of the year for a tax loss.

## January Effect Explanations

Beyond tax-loss harvesting and repurchases, as well as investors putting cash bonuses into the market, another explanation for the January effect has to do with investor psychology. Some investors believe that January is the best month to begin an investment program or perhaps are following through on a New Year's resolution to begin investing for the future.

Others have pontificated that mutual fund managers purchase stocks of top performers at the end of the year and eliminate questionable losers for appearance sake in their year-end reports, an activity known as "window dressing." This is unlikely, however, as the buying and selling would primarily affect large caps.

Other evidence supporting the idea that individuals sell for tax purposes includes a study by D'Mello, Ferris, and Hwang (2003), which found increased selling for stocks that experienced heavy capital losses before the end of the year and more selling of stocks with capital gains after the start of the year. Further, the trade size for stocks with large capital losses tends to decrease before year-end and for capital gains after the start of the year.

Year-end sell-offs also attract buyers interested in the lower prices, knowing the dips are not based on company fundamentals. On a large scale, this can drive prices higher in January.

## Studies and Criticism

One study, analyzing data from 1904 to 1974, concluded that the average return for stocks during the month of January was five times greater than any other month during the year, particularly noting this trend existed in small-capitalization stocks. The investment firm Salomon Smith Barney performed a study analyzing data from 1972 to 2002 and found that the stocks of the Russell 2000 index outperformed stocks in the Russell 1000 index (small-cap stocks versus large-cap stocks) in the month of January.