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January Effect a mixed bag

Like most market recipes, this one can mean different things to different people

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If this is January, we must be in the midst of the January Effect. Or are we?

Although it slumped somewhat yesterday, the Toronto Stock Exchange 300 index started the new year on a bold note, rising on Tuesday and then jumping almost 52 points to a new high on Wednesday on heavy volume.

So is that evidence of the January Effect? That depends on what you mean. Like most of the stock market's mixed bag of secret recipes, forecasting tools and other technical wizardry, it can mean a bunch of different things.

The phrase is usually taken to mean any or all of the following:

- That the market tends to do well in January.
- That its performance in January – or the first five trading days, depending which version you prefer – indicates how the rest of the year will turn out.
- That small-capitalization stocks do better than large-cap stocks in January.

The simplest and most widely accepted meaning is that the market usually does well in January. While there is little or no research on the subject in Canada, most people seem to agree this is probably true, if only because the flow of money into mutual funds and pension funds tends to be heavy leading up to RRSP season.

This, combined with tax-loss selling at the end of the previous year, can create a kind of January effect, market watchers say.

"You get a lot of funds and investors selling at the end of the year to take their tax losses or gains, and then there is buying in January as pension funds get funded and new money flows into the marketplace", says Doug Davis, principal of Toronto fund manager DAC Davis Investment Counsel.

In the United States, meanwhile, there appears to be no doubt that this simplified version of the January Effect exists.

The Stock Trader's Almanac, a treasure trove of analysis compiled by U.S. market veteran Yale Hirsch, shows that from 1950 to 1995 there have been 29 years with positive market movement in January and only 16 years in which the market fell that month.

And since there is "such a huge correlation between the Canadian and U.S. markets – except when [Bloc Québécois leader Lucien] Bouchard puts his foot into things – people usually accept that if the U.S. does well, then Canada will too", says Montreal-based technical analyst Ron Meisels.

The TSE 300 & January

	% change January	% change Year
'70	**−4.5**	**−6.4**
'71	**+2.1**	**+4.1**
'72	**+8.6**	**+22.0**
'73	+0.7	−3.6
'74	+0.6	−26.6
'75	**+14.1**	**+9.9**
'76	**+8.8**	**+3.9**
'77	−1.6	+4.7
'78	−5.8	+23.6
'79	**+3.5**	**+38.4**
'80	**+11.8**	**+25.1**
'81	**−1.9**	**−13.9**
'82	−8.6	+1.6
'83	**+2.3**	**+28.6**
'84	**−3.3**	**−6.0**
'85	**+8.1**	**+20.8**
'86	−2.0	+5.7
'87	**+9.2**	**+3.1**
'88	−3.3	+7.3
'89	**+6.7**	**+17.1**
'90	**−6.7**	**−18.0**
'91	**+0.5**	**+7.8**
'92	+2.4	−4.6
'93	−1.3	+29.0
'94	+5.4	−2.5
'95	−4.7	+11.9

As for whether the month determines how the rest of the year goes, the Trader's Almanac is also clear as a bell: "Nothing beats the January Barometer," Mr. Hirsch writes. "Since 1950, no other indicator has predicted the annual course of the market with such accuracy."

The market has followed January's pattern in 40 out of 45 years, for an 89-per-cent average. Mr. Hirsch says the phenomenon dates from the passing of the 20th Amendment to the U.S. Constitution in 1933. The effect was that Congress convenes in January and the president releases the budget – which inevitably affects the stock market.

Mr. Hirsch also discusses the refinement of the January Effect that the first five trading days are a kind of "early warning system" for the rest of the year. Again, he finds that these days have about an 89-per-cent correlation with what happens during the rest of the year.

Does January – either the month or the first five days – have the same predictive ability in Canada? No one is quite sure.

One market analyst who didn't want to be identified says he looked at about 40 years worth of data from the Toronto Stock Exchange and "didn't find [what happened in January] had any real predictive power."

In fact, this industry watcher says, "I walked away from it thinking it's overrated. Most of the time it's going to correlate positively just because most of the time the market goes up".

Here's a look at the past five years for the TSE 300 index:

- The index rose in January, 1991, by 0.5 per cent and climbed 7.8 per cent for the year over all.
- Although the index rose 2.4 per cent in January, 1992, it was down 4.6 per cent for the year.
- In 1993, the index dropped 1.3 per cent in January and yet the market rose 29 per cent during the year over all.
- The index climbed 5.4 per cent in January, 1994, but fell 2.5 per cent in the year as a whole.
- Last year, the index dropped 4.7 per cent in January but the market was up 11.9 per cent by the end of the year.

Nevertheless, ScotiaMcleod chief trader Fred Ketchen says "the January Effect is certainly accepted stock market folklore, and it probably does exist to some extent. If you have a few good weeks of trading, or even good days under your belt, it does something to instill confidence for the rest of the year."

Mr. Ketchen, a long-time market watcher, adds: "There's probably a certain amount of self-fulfilling prophecy to the thing too". In other words, if enough people believe there is a January Effect and trade stocks based on that assumption, such an effect is almost sure to be created.

The third part of the January Effect – that small-cap stocks tend to do better in that month – is also clearly borne out by research in the United States, such as that done by Ibbotson Associates in New York.

The Chicago Mercantile Exchange, which specializes in options, even advises that investors think about buying futures on an index such as the Standard & Poor's Low-Priced stock index or the Russell 2000 smallcap index, while selling futures on the larger S&P 500 index.

(*continued overleaf*)

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Investment ABCs: What is the Super Bowl theory?

WHAT do you make of a theory that is uncannily accurate but makes no sense whatsoever? That's the dilemma investors face when they consider the oddball Super Bowl theory.

The theory was dreamed up in 1979 by prominent U.S. money manager Robert Stovall, president of Stovall/Twenty-First Advisers, when he was chief investment strategist at Dean Witter Reynolds Inc.

While there are many twists to the theory, the basic premise is that the stock market will have a good year if one of the original 16 National Football League teams, rather than an original American Football League team, wins the Super Bowl, which is held each year on the last Sunday of January. The two leagues were merged in 1970 to form the present-day NFL.

This year, the result was bound to be favourable, because both the Dallas Cowboys and the Pittsburgh Steelers were part of the original NFL. (For those who didn't watch, the Cowboys defeated the Steelers by 27-17, a smaller than predicted margin).

The theory has been accurate an amazing 27 out of 30 times, or 90 per cent of the time, easily beating the record of virtually all other market indicators, not to mention gambling schemes.

"I think I've created a financial Frankenstein", says Mr. Stovall, who predicts a 20-per-cent gain in the Dow Jones industrial average in 1996. That advance is in line with the average gain the five previous times that two original NFL teams met.

The Super Bowl theory is just the tip of the looney-theory iceberg. For example, there's the always popular "bull market and bare knees" theory, which holds that markets rise and fall with the length of skirts, with shorter skirts reflecting greater optimism.

– Douglas Goold