

# The January Effect

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## Abstract

The purpose of this research paper is to analyse calendar anomalies and also explain different types of calendar anomalies with a particular emphasis on the January Effect. Through this paper we will try to understand possible explanations for January effect and to what extent it is valid.

**Keywords:** January effect, Calendar anomalies, Price, Demand

## 1. Introduction

My research paper explores the concept of calendar anomalies, with a specific focus on the January effect. It analyses various empirical studies and financial theories to determine the extent of the January effect's validity and its implications for investors and market efficiency. The paper concludes that while the January effect has historically demonstrated some validity, its significance has diminished over time, potentially due to increased market efficiency.

## 2. Calendar Anomalies

Calendar anomalies, also known as seasonal anomalies or calendar effects, refer to recurring patterns in financial markets or economic data that deviate from the expectations of the efficient market hypothesis. These anomalies challenge the idea that markets are always efficient and quickly adjust to new information. Researchers and investors study calendar anomalies to gain insights into market behaviour and potentially develop profitable trading strategies. Possible explanations for these anomalies include behavioural biases, liquidity fluctuations, tax considerations, and institutional practices. Understanding calendar anomalies has practical implications for investors and policymakers seeking to optimise investment strategies and regulate financial markets. These recurring patterns continue to be a subject of interest and research in the finance and economics fields, and understanding their causes and implications can contribute to a better comprehension of market dynamics.

## 3. Types of Calendar Anomalies:

### 1. January Effect

The January Effect is observed in financial markets, where stock prices tend to rise significantly during the month of January. It is characterised by a surge in stock prices, particularly for small-cap and lower-priced stocks, at the beginning of the new year. Despite its historical prominence, the exact reasons for this effect remain debated among researchers and market participants. However, the phenomenon has garnered attention for its potential impact on investment strategies and market behaviour.

### 2. Turn of the Month Effect

The Day-of-the-Month Effect is observed in financial markets, where stock returns display recurring patterns based on specific days of the month. Empirical evidence suggests that certain days tend to exhibit

abnormal returns consistently. For instance, the effect may reveal lower returns on Mondays and higher returns on Fridays. The phenomenon challenges the efficient market hypothesis, as stock prices are expected to fully incorporate all available information and show no systematic patterns. Researchers and investors study this anomaly to better understand market behaviour and potentially exploit it for trading strategies. The Day-of-the-Month Effect's underlying causes are subject to ongoing research and may involve factors such as investor behaviour, trading activity, or market liquidity fluctuations.

### **3. Day of the Week Effect**

The stock returns exhibit recurring patterns based on specific days of the trading week. Empirical evidence suggests that certain days consistently display abnormal returns over time. Notably, Mondays tend to experience lower returns compared to other weekdays, while Fridays often show higher returns. This phenomenon challenges the efficient market hypothesis, which assumes that stock prices rapidly adjust to new information and do not exhibit predictable patterns. The underlying causes of the Day-of-the-Week Effect are still a subject of research and may involve factors such as investor sentiment, liquidity fluctuations, and institutional practices.

### **4. Holiday Effect**

The Holiday Effect is a calendar anomaly observed in financial markets, where stock returns display abnormal patterns around specific holidays or holiday seasons. Empirical evidence suggests that stock prices tend to experience higher returns during certain holidays or festive periods compared to other times of the year. This phenomenon challenges the efficient market hypothesis, as stock prices are expected to fully reflect all available information and show no predictable patterns based on calendar events. Possible explanations for this effect include reduced trading activity during holidays, seasonal spending patterns, and changes in investor sentiment and behaviour during festive times. However, the exact causes of the Holiday Effect remain subject to ongoing research and analysis.

### **3. January effect (detailed)**

The January effect is a well-known and observed phenomenon in the financial markets, particularly in the context of the U.S. stock market. It refers to a pattern where small-capitalisation stocks tend to experience abnormally high rates of return during the month of January compared to other months of the year.

To understand the January effect, we need to first look at what small-cap stocks are. In the stock market, companies are classified based on their market capitalisation, which is the total value of a company's outstanding shares of stock. Small-cap stocks are those of relatively smaller companies with a lower market capitalisation compared to larger, more established companies.

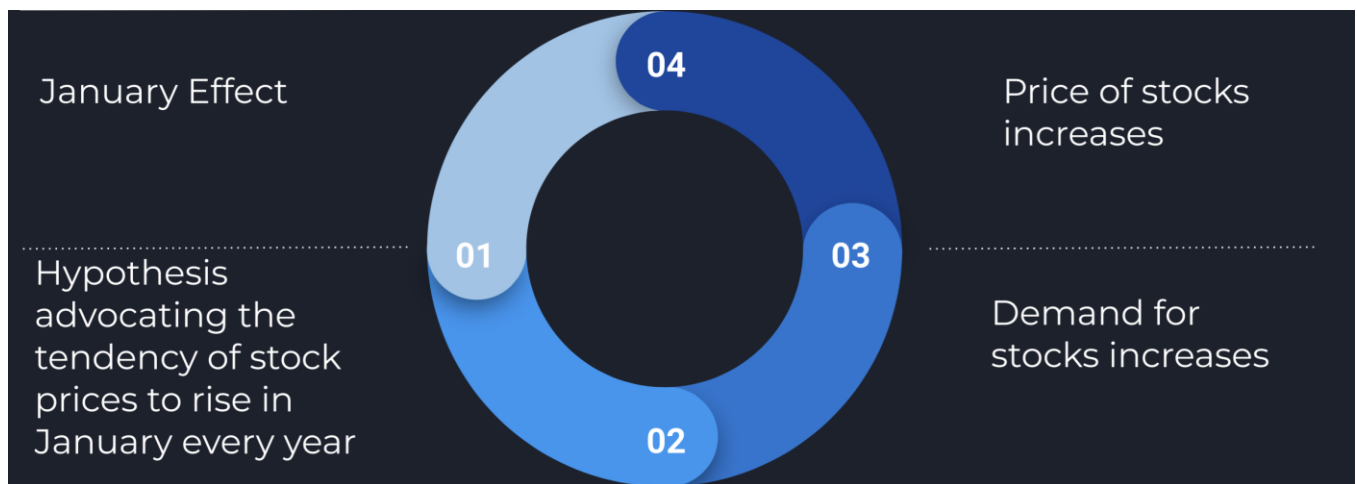
Now, imagine you have two hypothetical companies - Company A and Company B. Company A is a large and well-known corporation with a market capitalisation of \$10 billion, while Company B is a much smaller, relatively unknown company with a market capitalisation of \$500 million. During the month of January, investors tend to show a particular interest in small-cap stocks like Company B.

One reason for this interest is the idea that small-cap stocks may have more room for growth and potential for significant returns. Investors may be optimistic about the prospects of smaller companies, especially at the beginning of the year when they set their investment goals and strategies for the year ahead.

For example, let's say Company B, the small-cap stock, operates in a niche market with a unique product or service that has the potential to disrupt its industry. Investors who believe in the long-term potential of Company B might decide to buy its stock in January, driving up its demand and consequently increasing its price.

As a result, the stock of Company B experiences a higher-than-average rate of return during January. This pattern has been observed consistently over time, and that's why it's referred to as the "January effect." On the other hand, larger, more established companies like Company A may not experience the same surge in demand during January since they are already well-known and may have less potential for explosive growth compared to smaller companies.

It's essential to understand that the January effect is not guaranteed to occur every single year, and it may not be present in every market or region. It's more of a historical observation and pattern rather than a foolproof investment strategy.



#### 4. Literature review on

HaugMark, & HirscheyMark. (2006). The January effect. *Financial Analysts Journal*, 62(5), 78–88. <https://doi.org/10.2469/faj.v62.n5.4284>

The abstract discusses the "January effect" in the U.S. stock market. It states that small-cap stocks consistently exhibit abnormally high rates of return during the month of January. This effect has remained consistent over time and was not affected by the Tax Reform Act of 1986. The January effect challenges the efficient market hypothesis and suggests that behavioural explanations may be more relevant than tax-loss selling hypothesis.

The study uses data from 1802 to 2004 for value-weighted returns and 1927 to 2004 for equal-weighted returns to update evidence on the January effect. It confirms that the January effect persists for small-cap stocks and is also present in portfolios based on size and book-to-market factors. The size effect appears to dominate, indicating that smaller companies experience more significant January returns.

Additionally, the research reveals a persistently negative January effect for momentum stocks. This observation aligns with previous findings that individual investors tend to buy small-cap stocks abruptly in January.

Furthermore, the study finds that the January effect persists even after the enactment of the Tax Reform Act of 1986. The act required mutual funds to distribute at least 98 percent of realised capital gains and dividends during a specific period, leading to a belief that tax-motivated selling might influence the January effect. However, the presence of the January effect since 1987 weakens the argument for tax effects as the sole explanation for this phenomenon.

**5. Proof of January Effect:**

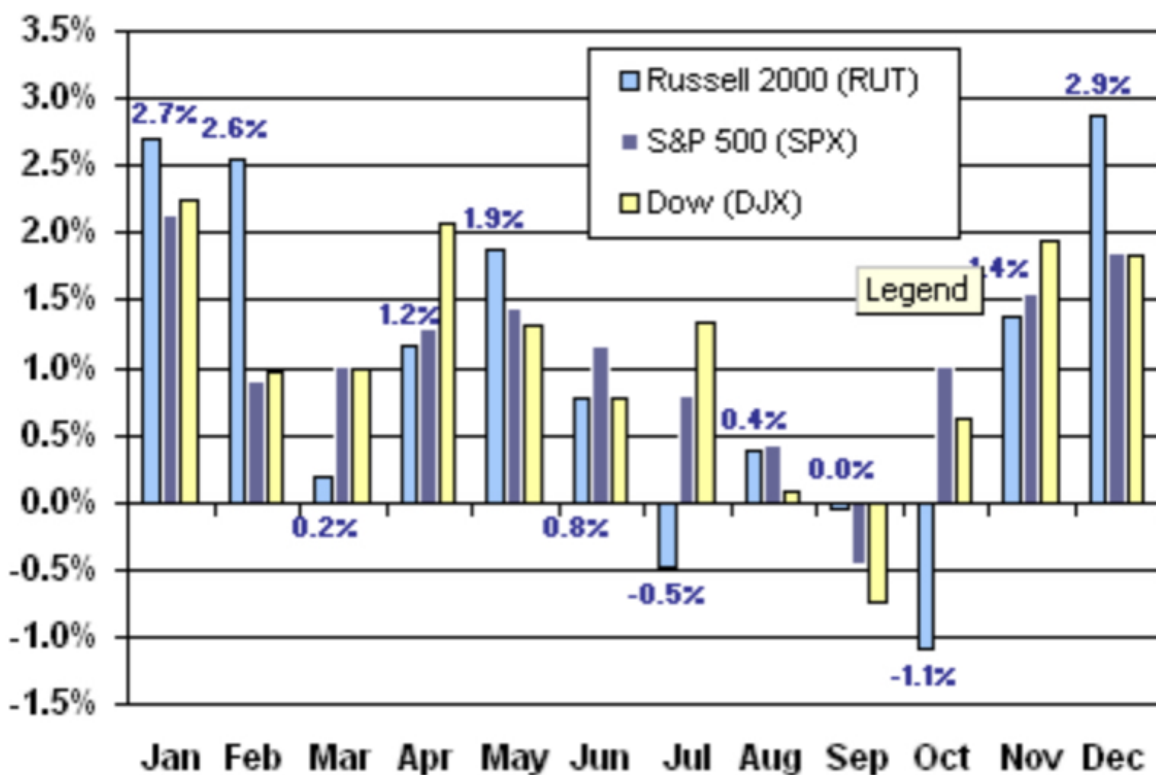
(Literature review)

Introduction to the January effect in the stock market. (n.d.). QuantShare Trading Software. <https://www.quantshare.com/sa-482-introduction-to-the-january-effect-in-the-stock-market>

To determine the credibility of various assumptions and theories surrounding the January effect in the stock market, it is crucial for investors to rely on quantifiable evidence. As market participants cannot predict the future, analysing historical data becomes the most effective means of gauging the validity of the January effect. Let us delve deeper into the evidence and non-evidence supporting this widely-discussed phenomenon.

The January effect proposes a rally in stock prices during the month of January, particularly observed in small-cap stocks. To support the existence of this effect, numerous approaches can be employed to gather relevant data. For instance, an examination of the average performance of major market indices, such as the S&P 500 (SPX), Russell 2000 (RUT), and Dow (DJX), over an extended period, say 20 years, can provide valuable insights. If the January effect holds true, there should be noticeable upward spikes in stock prices during January and possibly December as well, indicating a market trend for small-cap stocks to outperform during these months.

**Seasonality -  
Avg. Monthly % Price Change - 1980 - 2000**



A closer analysis of the historical data for the mentioned indices might reveal that the small-cap market, represented by the Russell 2000 Index, exhibits a more pronounced January effect compared to larger-cap counterparts. Investors and researchers might observe consistent patterns of higher returns in January for

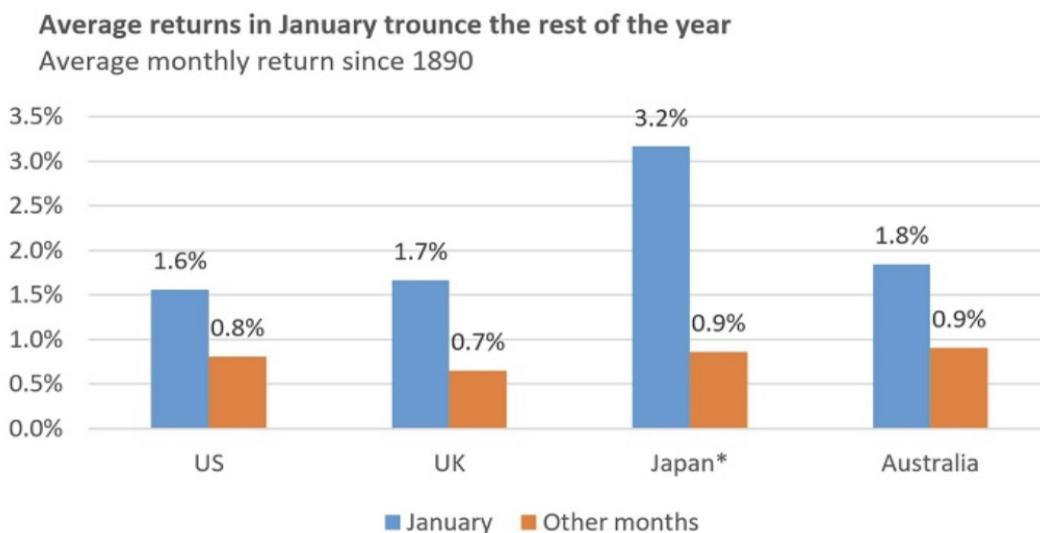
small-cap stocks compared to other months. However, when examining the same 20-year historical data for large-cap companies, it might show a lack of conclusive evidence supporting the January effect for this particular segment of the market.

In conjunction with the January effect hypothesis, researchers have extensively studied the performance of small-cap stocks compared to large-cap stocks over long periods. These studies often aim to ascertain whether small-cap stocks indeed outperform their larger counterparts consistently. One such notable research, led by Steven DeSanctis, a strategist at Bank of America Merrill Lynch, as well as Mark Haug and Mark Hirschey from the University of Kansas, focused on the period spanning from 1926 to 2004. According to their findings, the research confirmed that small-cap stocks indeed outperformed large-cap stocks around 70% of the time during the specified 78-year period. This quantitative evidence adds weight to the notion that there is an inherent advantage in investing in small-cap stocks over the long term, potentially supported by the January effect's influence.

The January effect remains a fascinating subject of study in the financial markets. While the evidence supporting the phenomenon's existence seems promising, it is essential to remember that the stock market is subject to a multitude of complex factors that can influence short-term performance. Investors should approach the January effect and other market anomalies with careful consideration, using historical data as one of several tools to make well-informed investment decisions. Diversification, risk management, and a long-term perspective should continue to be guiding principles for investors seeking to navigate the dynamic and ever-changing world of finance.

### 6. Another example of January Effect:

Examples of January effect stocks in 2021 include Occidental Petroleum, which was down 55% in 2020, gained 24% in 2021, and Continental Resources, which fell 52% in 2020 and recovered 17% during 2021.



\* Japan data is since 1921. Source: Global Financial Data, Refinitiv and Schrodgers. Data to December 2019

### 7. Possible explanations for January Effect:

**1. Tax-Loss Selling Hypothesis:** One of the early explanations for the January effect is the tax-loss selling hypothesis. Toward the end of the calendar year, investors who have experienced losses in their stock holdings might sell these losing positions to realise capital losses for tax purposes. This tax



strategy allows investors to offset gains from other investments, reducing their overall tax liability. After the new year begins, these investors might re-enter the market, leading to increased demand and higher prices for small-cap stocks, which could result in the January effect.

2. **Window Dressing:** Another theory suggests that institutional investors, such as mutual funds, engage in window dressing at the end of the year. Window dressing involves selling poorly performing stocks and buying high-performing ones to make their portfolios appear more favourable to their clients or shareholders. After the year-end reporting period, they may reverse these actions, leading to increased buying pressure on small-cap stocks in January.
3. **Investor Sentiment:** Investor sentiment plays a significant role in financial markets. At the beginning of the year, investors often have a renewed sense of optimism and may set new investment goals. This positive sentiment might lead them to invest in riskier assets, such as small-cap stocks, which can result in higher demand and price appreciation during January.
4. **Year-End Fund Flows:** The end of the year is a common time for investors to receive bonuses, holiday gifts, or year-end distributions from investment funds. Some of this money might find its way into the stock market, potentially boosting demand and prices for small-cap stocks in January.
5. **Market Liquidity:** Market liquidity, which refers to the ease of buying and selling assets without significantly impacting their prices, can vary throughout the year. In some cases, lower liquidity during the holiday season might lead to higher price volatility and exaggerated returns for small-cap stocks in January.

## 8. Declining January Effect

Gu, A. Y. (2003). The declining January effect: evidences from the U.S. equity markets. *The Quarterly Review of Economics and Finance*, 43(2), 395–404. [https://doi.org/10.1016/s1062-9769\(02\)00160-6](https://doi.org/10.1016/s1062-9769(02)00160-6)

The January effect has shown a significant decline in both large and small firm stock indices since 1988, and this effect seems to be disappearing for the Russell indices. A similar declining trend has been observed in the Dow 30 since 1930. Although there was an upward trend in the Dow 30 and the S&P 500 from the post-war period through the 1970s, excluding the years with extremely high January returns in 1975 and 1976 results in flat trend lines. The decline in the January effect is more evident in indices containing small stocks compared to those of large stocks.

Furthermore, the January effect demonstrates a negative correlation with actual and expected real GDP growth, inflation, and the overall return of the year. However, it is positively associated with volatility. The power ratio method has been utilized to consistently determine the relative contribution of January returns in the overall yearly performance. The changes in the anomaly's pattern have implications for investment strategies.

In summary, the January effect has shown a diminishing trend in recent years, particularly for small stocks. The effect's correlation with various economic indicators and market variables suggests that it may be influenced by broader economic conditions. Investors should consider these trends and correlations while formulating their investment strategies.

## 9. Conclusion

In conclusion, the January effect is a well-documented phenomenon in the financial markets, where small-cap stocks tend to experience abnormally high rates of return during the month of January. While the existence of the January effect has been supported by historical data and numerous research studies, it is

essential to recognise- that the strength and presence of the effect can vary from year to year and across different market conditions.

The January effect has been a subject of significant interest and debate among investors and researchers alike. Various theories have been proposed to explain the phenomenon, including tax-loss selling, window dressing, investor sentiment, year-end fund flows, and market liquidity. However, the precise reasons behind the January effect remain elusive, and it is likely influenced by a combination of factors.

Investors should approach the January effect, or any market anomaly, with caution. Relying solely on past trends or historical patterns to make investment decisions may not yield consistent results. Diversification, risk management, and a long-term investment approach are fundamental principles that should guide investors in navigating the complexities of the financial markets.

As with any investment strategy, thorough research and analysis are essential for making informed decisions. Understanding the broader market trends, economic conditions, and company-specific factors is vital in developing a well-rounded investment strategy. Moreover, investors should be prepared for the possibility that the January effect may continue to evolve or fade over time, as markets and economic dynamics change.

While the January effect has provided valuable insights into market behaviour, it should not be the sole basis for investment decisions. Instead, investors should focus on building diversified portfolios, aligning with their risk tolerance and financial goals, and remaining attentive to market developments to achieve long-term success in their investment endeavours.

Moreover, the January effect has significantly declined in recent years as it has become less evident. Although, it still exists. In reality, its intensity and frequency have decreased since its identification.

#### **10. References and Citation:**

1. HaugMark, & HirscheyMark. (2006). The January effect. *Financial Analysts Journal*, 62(5), 78–88. <https://doi.org/10.2469/faj.v62.n5.4284>
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