



Do Market Theories Really Work?

People are always quoting market theories such as the January Effect, sell in May and go away and the election year theory, but do they really work, or at least work the majority of the time?

Let's take a look at a few of these theories to evaluate their effectiveness, beginning with the "January Effect" given the recent results in January 2014, 2015 and 2016. The January Effect states that stock prices tend to increase in the month of January due to increased buying. Why is there more buying in January? The theory states that in an effort to reduce year-end tax gains, an investor will sell securities that generate a tax loss as an offset. Theoretically this behavior should lead to a high degree of selling in December and subsequent increased buying in January as these same investors repurchase their holdings. We've selected the S&P 500 Index for illustration purposes. Table 1 provides January performance data over the last 50 years. What the data reveals is that the S&P 500 Index posts positive performance 58% of the time, just slightly more than half, while the average return over the period is 1.11%. As a follow-up, we looked at small cap stocks using the Russell 2000. Though this data set was slightly smaller given the index launch date, the result was similar, the index posted positive results 54% of the time. Thus, if an investor were to bet that their equity holdings would produce positive results in January based on the "January Effect" theory each year, they will likely only be correct slightly more than half the time.

Table 1

S&P 500 Index Performance (%)		S&P 500 Index Performance (%)	
Date	for the Month of January	Date	for the Month of January
1/31/1966	0.49	1/31/1991	4.34
1/31/1967	7.82	1/31/1992	-1.86
1/31/1968	-4.38	1/29/1993	0.84
1/31/1969	-0.82	1/31/1994	3.40
1/30/1970	-7.65	1/31/1995	2.59
1/29/1971	4.05	1/31/1996	3.39
1/31/1972	1.81	1/31/1997	6.24
1/31/1973	-1.71	1/30/1998	1.10
1/31/1974	-1.00	1/29/1999	4.18
1/31/1975	12.28	1/31/2000	-5.02
1/30/1976	11.83	1/31/2001	3.55
1/31/1977	-5.05	1/31/2002	-1.46
1/31/1978	-6.15	1/31/2003	-2.61
1/31/1979	3.97	1/30/2004	1.84
1/31/1980	5.76	1/31/2005	-2.44
1/30/1981	-4.18	1/31/2006	2.65
1/29/1982	-1.31	1/31/2007	1.51
1/31/1983	3.72	1/31/2008	-6.00
1/31/1984	-0.56	1/30/2009	-8.42
1/31/1985	7.79	1/29/2010	-3.59
1/31/1986	0.56	1/31/2011	2.37
1/30/1987	13.47	1/31/2012	4.48
1/29/1988	4.20	1/31/2013	5.18
1/31/1989	7.30	1/31/2014	-3.46
1/31/1990	-6.71	1/30/2015	-3.00
Positive months		58%	
Average		1.11%	



Now, let's move to the old adage "sell in May and go away". This theory suggests that it is better not to own stocks during the summer months (May-October), as these tend to be popular vacation months, theoretically lowering trading volumes and heightening volatility. The idea is to sell equities on April 30th and hold cash until November 1st. So, let's see if this theory holds. Columns 3 and 6 in table 2 provide annual performance for the S&P 500 Total Return Index, while in columns 2 and 5 we have the same year return less performance for the months of May-October. Again, using a 50-year data set, the theory only works on 14 years or 30% of the time, not a theory to bet money on!

Table 2

S&P 500 Index Performance (%)		S&P 500 Index Performance (%)		S&P 500 Index Performance (%)	
Date	Performance: Jan-Apr, Nov-Dec	Full Calendar Year	Date	Performance: Jan-Apr, Nov-Dec	Full Calendar Year
12/30/1966	-1.32	-13.09	12/31/1991	22.70	29.94
12/29/1967	20.23	20.09	12/31/1992	5.01	7.44
12/31/1968	1.60	7.66	12/31/1993	2.09	9.93
12/31/1969	-5.48	-11.36	12/30/1994	-4.71	1.27
12/31/1970	-1.98	0.10	12/29/1995	20.16	37.08
12/31/1971	22.21	10.79	12/31/1996	12.69	22.64
12/29/1972	11.58	15.63	12/31/1997	15.78	33.07
12/31/1973	-18.37	-17.37	12/31/1998	29.07	28.30
12/31/1974	-14.11	-29.72	12/31/1999	17.81	20.87
12/31/1975	28.98	31.55	12/29/2000	-8.16	-9.03
12/31/1976	17.69	19.15	12/31/2001	3.18	-11.86
12/30/1977	-5.66	-11.50	12/31/2002	-6.12	-21.97
12/29/1978	5.05	1.06	12/31/2003	11.28	28.34
12/31/1979	12.24	12.31	12/31/2004	7.69	10.74
12/31/1980	7.19	31.06	12/30/2005	-0.34	4.83
12/31/1981	0.87	-4.85	12/29/2006	9.11	15.60
12/31/1982	2.74	20.37	12/31/2007	0.08	5.56
12/30/1983	20.55	22.31	12/31/2008	-10.92	-36.55
12/31/1984	-0.01	5.97	12/31/2009	5.37	25.92
12/31/1985	22.20	31.05	12/31/2010	14.22	14.82
12/31/1986	12.61	18.54	12/30/2011	9.91	2.09
12/31/1987	18.76	5.67	12/31/2012	13.53	15.88
12/30/1988	7.15	16.34	12/31/2013	19.09	32.04
12/29/1989	17.67	31.22	12/31/2014	5.04	13.52
12/31/1990	3.44	-3.22	12/31/2015	0.60	1.37

works 28%
Average Jan-May/Nov-Dec Return 7.60%
Average Full Year Return 9.83%

Finally, since we are in an election year, let's look at a political theory and how presidential election years tend to be positive for stocks. Table 3 provides the S&P 500 Index results during election years over the last 50 years; with the exception of 2000 and 2008, performance has been solid. Why does this happen? The theory suggests politicians want to be reelected and preferring not to rock-the-boat, they choose not to make any controversial decisions or changes in that year. So, what will happen in 2016, your guess is as good as ours, but if this theory holds, we should have a good second half of 2016.



Table 3 (50-year data set)

Date	S&P 500 Index Performance (%) In Election Years
12/31/1968	7.66
12/29/1972	15.63
12/31/1976	19.15
12/31/1980	31.06
12/31/1984	5.97
12/30/1988	16.34
12/31/1992	7.44
12/29/2000	-9.03
12/31/2004	10.74
12/31/2008	-36.55
12/31/2012	15.88

works 82%
Average Return 7.66%

In conclusion, we hope this paper has shed a bit of light and a basic understanding on three long-term, well established investment theories. Market theories arise as research uncovers historical investment patterns that have held-up enough overtime to warrant a rationale. Though these explanations may in fact make sense and play out some or even much of the time, the definition of a theory is “an idea that is suggested or presented as possibly true but is not known or proven to be true”, which indicates that taking these or any market theory as gospel would be a mistake. In general, we believe investment decisions should be made strategically and with a long-term view. While market theories may act in our favor at times and we are not opposed to benefiting from such activity, in general, we prefer to remain focused on a client’s asset allocation and underlying investments as it pertains to their individual return and risk objectives.