



>: How to Profit From "The January Effect"

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As we finish up the year and you are wondering what to expect from the stock market, keep in mind that we are going into the time period when we almost always experience what we call "the January effect."

"The January effect," is a term that says that small-caps generally *outperform* large-caps in January (and in the more recent years, this performance starts in the end of December.)

Just because the January effect usually happens, it is obviously not a guarantee.

The first part of the January effect is essentially an occurrence that causes selling pressure at the end of the year on small cap stocks, especially the ones that underperformed the market.

There are two main reasons that the January effect takes place.

- 1) Tax Selling
- 2) Window Dressing

What happens is investors who own stocks that are under water sell those positions for a tax-loss, which they use to either write off the year's gains, or to carry forward for future write-offs. And the tax selling isn't limited to the stock positions with losses. Obviously, investors also sell stocks to take gains against the year's losses.

Investors who are looking at which stocks to sell for tax purposes tend to look at the small-cap stocks as stocks that they want to sell since large-cap stocks are more likely to be the long-term positions which are held through thick and thin.

Although the January effect is caused by individuals as well as institutions, the pressure on stocks *due to tax selling* comes mainly from the individual investors.

The institutions play their part as they are generally trying to make sure that they don't get fired for having owned the biggest dogs of the year in their fund.

This is when money managers who have losses on their books in small-cap stocks, which are considered to be more aggressive, cut their losses and re-invest that money into blue chip stocks.

They simply wipe those aggressive dogs right out of their portfolio to highlight the quality names in their fund, or at least the winning (albeit lower quality) names for the year.

This sell-off then sets small -caps up for a rally to the upside

as investors jump back in. The small-cap jump (in more recent years) usually occurs from about December 19 to January 5. Although this small-cap rally used to happen in the beginning of January (hence the name,) people caught wind of this phenomenon.

It happens partially because people who sold the down stock in their portfolios for a tax-loss get back in to the stock after waiting the mandatory 30 days to realize the tax-loss.

Another reason that you typically see a rebound is that the selling pressure has enticed the bargain hunters to step in mid-December, and buy the sold off stocks.

Many of these bargain hunters are aware of the fact that small-caps tend to underperform simply due to the January effect, and they buy because they anticipate the buying to shift back to the small-caps again through late December/early January.

Small-cap stocks are also historically the best performers on this rebound because money managers and other institutions are willing to invest in more aggressive names in the end of December/beginning of January.

Historically, markets are pushed higher also because of the retirement money being pumped into the market by Pension funds, Profit-Sharing plans, IRAs, 401ks and so on.

Also adding to the January effect (which again has started in mid-December in recent years) are holiday gifts, year-end bonuses, and distributions.

So be sure to keep an eye on small-cap oversold dogs, and the small-cap stocks that you wanted to own, but ran away from you. If you are a bargain hunter, you might have a holiday gift presented to you this December.

At the same time, if you are currently looking for stocks to lighten up on because you feel that it's time to reduce your exposure to the market, then consider lightening up on the small cap stocks first over the next week or two. You wouldn't be the only one doing so.

But one word of caution: I wouldn't be **too** aggressive about this.

What I mean is that I wouldn't be looking for small-cap stocks to short, *just because of the January effect*. If you are looking to choose between 2 different stocks to short, and you feel *just as strongly* about both potential trades, and one is small-cap and the other is large-cap, then from mid November through mid December, I would short the small-cap.

I mean, the entire market might trade higher, but the idea is that if it trades higher, small-caps tend to be the weaker group starting in about 1 week from now through about December 19th.

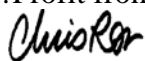
On the same token, if the entire market trades *lower*, small-caps still tend to be weaker performer in that time frame.

After approximately December 19th is when you generally see the opposite (small-caps usually out-perform large caps.)

Here's where I'm coming from in a nutshell:

In my options trading service "The Trend Rider" I almost always have both bullish and bearish positions open, because I like to make money whether the market moves up or down. While most of the *current* open positions are bullish positions, I'm looking at several stocks that look like they are about to tank, which I want to recommend the purchase of put options on. If the market trades higher, I still think that the stocks tank, but if we go lower, as they say back home (NYC) "foggetabatit!"

?Profit from the Trend?



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