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January’s Stock Temptation
By STEPHEN J. CICCONE

IN the first three weeks or so of trading this year, the Standard & Poor’s 500-stock index, a measure of the broad market, has climbed more than 4 percent — and on Jan. 18, in fact, closed at its highest level since December 2007. Last January, the S.&P. 500 rose 4.4 percent — a blistering pace that, if kept up for the rest of 2012, would have translated into a compound annual return of nearly 67 percent. (Alas, it did not.) January 2011 was also a hot one for stocks, its monthly return translating into an annualized gain of 31 percent.

Mention such returns to the average Wall Street type and you’re likely to get a yawn. Going back to the 1920s, after all, the first month of the year has, with striking regularity, been a great time to invest — a phenomenon known, fittingly, as “the January Effect.”

First discussed in a 1942 article by the investment banker Sidney B. Wachtel, this celebrated winter anomaly has two components: the stock market tends to do well over all in January, and small-company shares typically outperform large stocks. For the rest of the year, the latter trend often reverses, and big stocks beat the small fry.

Why exactly the January Effect persists is a mystery — in an efficient market, such calendar-driven bonanzas aren’t supposed to happen.

Some believe the phenomenon is a result of tax-loss selling: investors dump their loser stocks in December to recognize a capital loss and then buy them back in January, pushing up share prices. Others say it’s because of institutional money managers, who shed their weakest-performing or riskiest-looking small stocks before Dec. 31 so that their reported year-end holdings look better to clients. Like the tax-loss sellers, these “window dressers” return to buying when the calendar turns anew.

But what if the January Effect has a more fundamental cause — one that ties directly to human nature?

In a paper published in The Journal of Behavioral Finance in 2011, I proposed that this most famous of regular irregularities in the stock market was attributable to our strong inclination to be optimistic at the turn of the year. Investors, exhibiting the same flash of wishful thinking exuded by any New Year’s resolution maker, take a flier on those little stocks that “have great potential.” Then, as the hopefulness fades over the year, the January could-bes fall back into might-have-beens, typically doing a little worse than the market as a whole.

For an experiment that might test this hypothesis, I gathered a portfolio of stocks particularly susceptible to optimism — those for which Wall Street analysts had sharply varying opinions.
regarding their prospects, with some analysts wildly upbeat in their assessments and others quite pessimistic. I argued that in January, share prices would reflect the optimistic view rather than the gloomy one and that in the rest of the year the opposite would occur — a pattern that monthly stock returns later bore out.

What’s more, recent research on the brain suggests that some human beings are hard-wired for such optimism. Using functional magnetic resonance imaging, the neuroscientist Tali Sharot, at University College London, and her team have been **studying** communication between the brain’s frontal cortex and subcortical regions deep in the brain; inveterate optimists, it seems, tend to have stronger communication links between these areas.

Whether or not this brain cross-talk spikes in January is an open question — as is another major piece of the puzzle: Why doesn’t the January Effect disappear in anticipation of the January Effect, as investors try to take advantage of what’s coming? I believe that the “false hope syndrome,” a notion that has been explored by the psychologists Janet Polivy and C. Peter Herman, may account for some of the reason.

The theory is that people are optimistic at the turn of the year and often make idealistic resolutions: lose 50 pounds, write that novel, cut down the binge spending or make a windfall in the stock market. As the year progresses, they fall short of their goals and eventually forget or give up. But come next January, the goals are back, starting the cycle of failure and renewed effort all over again.

Looking further into brain activity, Dr. Sharot and her team may have found why false hopes exist neurologically. They contend that unrealistic optimism is a pervasive human trait. Evaluating how this **optimism is maintained** in the face of information that challenges it, they found that desirable information was encoded in a different part of the brain than undesirable information.

Optimists and pessimists both process desirable information effectively, but the brain neurons of extreme optimists do not effectively encode undesirable information. This reduced ability to remember disappointments is probably an advantage for many people — like professional athletes, who need confidence after tough losses. But for investors looking for long-term winners at the start of the year, it’s best to give yourself a gut check before you buy.

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