Mitch on the Markets

Could the "January Effect" Benefit Small-Cap Stocks?

By Mitch Zacks
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The real title of this article probably should have been: "How the January Effect Could Benefit Small-Cap Stocks – *And What You Should Do About It."* At Zacks Investment Management, we have long advocated for the inclusion of small-cap stocks as part of a broadly diversified equity strategy. Small-caps have tended to outperform mid- and large-cap stocks over very long stretches of time, and if chosen wisely they have potential to add solid alpha to an investor's portfolio.

The January Effect is less an investment principle than it is a reminder that small-caps deserve a legitimate seat at the table. Like "Sell in May and Go Away," the "January Effect" is one of those clichéd calendar trends that often works enough to grab investor attention but is far from a sure thing (nothing with investing is). Below we'll explain what the January Effect is, how it arguably benefits small-cap stocks, and what you should do about it.

Explaining the January Effect

The so-termed January Effect was first noticed in the 1940's by an investment banker named Sidney Wachtel. At that time, it was just a very basic observation that stocks tended to bounce in January, particularly small caps. The hypothesized rationale behind the January rally in stocks was based in the following logic:

1) Tax-Loss selling at the end of the calendar year causes many stocks to fall to lower valuations, therefore making them attractive buys at the beginning of the New Year.
2) Big Wall Street bonuses were typically falling to the beginning of the year, and capital was being deployed into bargain stocks that were losers the previous year.
3) Portfolio managers would sell losers at the end of each year because they wanted to show investors they were actively getting rid of poor performers, which drove those stock prices even lower.

The theory goes that the annual combination of lower prices and fresh new capital were driving stock prices higher, or at least creating conditions conducive to rising prices. Small-caps historically emerged as the category that benefited the most from this effect.

How Investors Should Position for the January Effect

Like other 'calendar' stock market effects, the January Effect is far from a reliable indicator. Over time it will probably work just as many times as it doesn't. In fact, 2016 was an example of its shortcomings – the market underwent a fairly steep correction that spanned just about the entire month, and hit all categories of stocks. Betting on the January Effect this year would have been as disappointing as it gets.

Betting on small-cap, however, would not have been disappointing if you stuck with it for the entire year. Small-cap stocks have outperformed the S&P 500 by a pretty handy margin so far, so investors with small-cap exposure in their portfolios stood to gain a nice bit of alpha over the broad large-cap indices.

Bottom Line for Investors

Looking ahead, the environment could be shifting back in favor of small- and mid-cap stocks, as the proposed lower corporate tax rates and infrastructure spending plans could help profitability in domestic and cyclical categories, where small-caps tend to thrive. Our advice to investors who desire growth and equity exposure in their portfolios is to have exposure to the small-cap category as part of a broadly diversified portfolio. Additionally, we advise investors to keep their risk tolerance in mind when evaluating exposure to the small-cap category. At Zacks Investment Management, we have solutions to help investors gain that exposure at the hands of professional, experienced managers. To learn more about our small-cap products and our track record in the space, please reach out to us directly at 1-800-245-2934.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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