

Sell in May and Go Away?

A charm and curse of the stock market is the entertaining, but ultimately destructive, panoply of magic rules, wonder indicators and inside tips that dominate much conversation about investing. Most cross into numerology, unsupported by fact or probability. Magic indicators are considered by the investing public as equally true, by academics as equally false and by brokers as equally useful. Many of the “rules” commit the intellectual crime of confusing correlation and causation – if you torture the data long enough, you can find a relationship between the stock market and rainfall in Newfoundland or strikeouts by pitchers on the Colorado Rockies, but do you want to risk your money on that “rule” going forward?

Still, part of our job is to overlook nothing that might help us invest the money of our clients. When we have some free time and tire of pondering matters such as why “phonetic” is not spelled the way it sounds, we consider interesting market indicators, even if we are challenged to explain them. For example, consider the four-year ebb and flow of presidential politics. The presidential election year and the previous year generally see good stock market returns, while returns tend to be lackluster the year after an election and the following year. The theory is that an administration does everything in its power to pump up the economy in anticipation of the election so that a happy electorate votes to stay the course and keep the incumbent party in control. After an election, regardless of who wins, we must pay the piper.

The worst year of the four is the mid-term Congressional election year – like 2006. Students of political science wondering about the relative strength of the executive and legislative branches need look no farther for evidence. At least as far as the stock market is concerned, the President drives the agenda, not Congress.

Another old investing rule is “sell in May and go away.” While this sounds like a thinly veiled excuse by vacationing investment managers, the stock market tends to do well in the seven months from the fall through mid-spring, but not so well during the other five months from mid-spring through summer. According to Ned Davis Research, since 1930 the Standard & Poor’s 500 index of large U.S. stocks has gained 5.55 percent (not including dividends), on average, from September 30 through April 30, but only 0.31 percent, on average, from April 30 through September 30. If we combine the two indicators and only consider the 20 mid-term election years (like 2006) since 1930, the average gain by the S&P 500 during the “good” seven months ending on April 30 was only 0.51 percent. In the 19 “bad” five-month periods during mid-term election years since 1930, the S&P lost 3.46 percent on average.

There are critics of the “sell in May” strategy who believe that just a few volatile occurrences drive the average returns. In the record we cite from Ned Davis, however, the average returns are very close to the median returns, suggesting that just a few instances are not skewing the data. In addition, the seasonal pattern is neither just a United States phenomenon nor a recent one. In one study*, the seasonal effect was noticeable in England all the way back to 1694 and, more recently, in 36 of 37 developed and emerging markets studied. The authors conclude that none of the possible explanations they considered convincingly explains the seasonality.

The problem with the long-run is that you have to live through a bunch of short-runs to get there.

For the stock market, we are currently in the worst seasonal period during the worst year of the presidential election cycle. Should we really just sell in May and go away through September? The record of the indicators has been sturdy but not infallible.

1982, 1986 and 1998 were all mid-term election years, and the index was up substantially in each. Could you have sat with equanimity in cash while the market went up? Even combining the election cycle and seasonal pattern, the market was up in the “bad” period in mid-term election years almost half the time. It is one thing to look at long-term historical averages, but quite another to actually live through the short-runs that make up the long-run.

The indicator record is interesting, but erratic enough that we are not just going to sell out all client equity holdings until October. On the other hand, it confirms our already cautious current stance in an over-priced stock market. Even if an indicator has some merit, we prefer to think of it as if we were kayaking. If a reliable indicator indicates the likelihood of a buoyant market, it is as if we are kayaking downstream, with the current, simple and, except for the occasional class IV rapid, safe. If a reliable indicator tells us of the likelihood of troubling times, it is as if we are kayaking upstream. Going against the current, progress is possible, just difficult. So enjoy your summer – and leave the paddling to us. Call us at 503-419-3938 or check us on the web at www.sigmainvestment.com.

*The Halloween Indicator, ‘Sell in May and Go Away’: Another Puzzle by Ben Jacobsen and Sven Bouman (2001); http://papers.ssrn.com/sol3/papers.cfm?abstract_id=76248