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MARK HULBERT

Is January special after all?

By Mark Hulbert, CBS.MarketWatch.com
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ANNANDALE, Va. (MarketWatch) -- Hold the presses. It turns out that January may have special powers to predict the rest of the year, despite my recent column suggesting that any abilities January may have in this regard are not unique.

(Read archived column.)

As Paul Harvey might say, there's the "rest of the story." And the rest of the story in this case is provided by a just-completed academic working paper by Michael J. Cooper and John J. McConnell of Purdue University and Alexei V. Ovtchinnikov of Virginia Tech. Their study is not yet published, but Prof. Cooper tells me that you can obtain a copy by e-mailing him at mcooper@purdue.edu.

Their research takes on added urgency because all the major market averages currently are sporting losses for January to date. Following its loss of more than 68 points on Thursday, for example, the Dow Jones Industrials Average ($INDU :

11,642.65, +2.88, +0.0%) now needs to gain more than 300 points over the next seven trading sessions to not show a loss for the month.

For those of you who don't remember my recent column, I reported that most months of the year, not just January, do a creditable job of foretelling the stock market's direction over the subsequent 11 months. In fact, I found, April and November have a better statistical record in this regard than January. I based my column on a Hulbert Financial Digest study of the DJIA dating back to 1896, when this benchmark was created.

According to Prof. Cooper and his colleagues, these HFD findings are largely a function of what happened during the 1930s. In that decade, January did a horrible job predicting the market's direction for the rest of the year: On average, positive Januaries were followed by terrible years, while negative Januaries were following by wonderful years.

Anyone who invested according to the so-called January Indicator during the 1930s therefore lost a lot of money. Any historical study whose focus includes that decade therefore will tend to be swayed away from the notion that January has special predictive power.

Another fascinating finding from the researchers: During the 1930s, some of the non-January months did an impressive job of foretelling the market's direction over the subsequent 11 months. This especially was the case for April and November, for example.

If we ignore this decade, according to Cooper and his co-authors, then two things simultaneously happen.

First, the non-January months lose their apparent predictive power. And January's ability to forecast the rest of the year becomes stronger.

The net effect of ignoring the 1930s is to make January appear unique in its ability to predict what the market will do over the subsequent 11 months.

What importance should you as an investor put on the findings of this new study? It depends in part on whether you think the 1930s should be ignored. If you think they should be, then you can place greater confidence on the January Indicator than I originally gave it, since Cooper and his colleagues report that January's predictive abilities since 1940 have been statistically quite significant.

If, in contrast, you see no good statistical reason to ignore the 1930s (and I don't), then you will be less inclined to place importance on the January Indicator.

Even if you are willing to overlook the 1930s, however, there's another hurdle you need to jump over before basing your investment strategy on the January Indicator: You need a plausible explanation for why the indicator should work. Without such an explanation, then you run a big risk that the indicator is based on nothing more than a fluke of the data.

My favorite example of why this is so comes from David Leinweber, a visiting faculty member in CalTech's economics department. Several years ago, wanting to illustrate the perils of mining the data for spurious correlations, he searched through all the data on a United Nations CD-ROM to find the indicator with the most statistically significant correlation with the S&P 500. His discovery: butter production in Bangladesh.

So statistical correlation is not, in itself, a sufficient reason to alter your strategy.

Is there a plausible explanation for why January should have special ability to predict the market's direction over the subsequent 11 months? I am not aware of any. Nor are Cooper and his colleagues, who write that after investigating any of a number of possible explanations, they essentially came "up empty."

This does not guarantee that the January Indicator has no validity. But, in my opinion, it suggests that acting on it is very risky indeed.

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Mark Hulbert is the founder of Hulbert Financial Digest in Annandale, Va. He has been tracking the advice of more than 160 financial newsletters since 1980.

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