OPINION

Why this year in particular investors should sell in May and go away

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Say you are a portfolio manager and January to April you are up 15 per cent for the year (not an unrealistic number for many). What will you do to safeguard your Christmas bonus considering plenty of signs of market exuberance amid economic and geopolitical risks?

Even value investors who invest bottom up have started to worry top down – that is, they worry about macro and global risks. And there are a lot of top-down worries now.

My crystal ball says that portfolio managers will be heavy sellers of equities in May, in line with the adage "sell in May and go away." And there is plenty of academic research that supports the existence of that pattern. The phenomenon is alive and well when you look at recent average returns, and it can provide profitable investment opportunities – especially if one reinvests those stock sales into government bonds until the end of October.

My research shows that the average annual rate of return over a 60-year period starting in 1957 would have been 17 per cent had investors:

1. Invested in an equally weighted index in November-April

2. Got out of risky securities altogether in the May-October period and;

3. Over that May-October period instead invested heavily (and exclusively) in Government of Canada bonds. The gain would have been 18 per cent in the 1988-2018 sub-period.

(For this research, I used an equally weighted index of all Canadian stocks and a long-term Government of Canada bond index.)

One needs to understand the powerful drivers of this phenomenon before casting a negative opinion of it – and I have seen a lot of commentary in the media ridiculing the belief in its existence. This seasonal pattern rests on human psychology and the conflicts of interest of professional portfolio managers.

Professional portfolio managers' own agendas and their efforts to maximize their own benefits lead them to rebalance portfolios and window-dress in a predictable way throughout the year.

The high average returns on risky securities in the beginning of the year are caused by systematic shifts in the holdings of professional portfolio managers who rebalance their investments to affect performance-based remuneration. Institutional investors are, on average, net buyers of risky securities early on in the year when they are motivated to include less-known, high-risk securities in their portfolios and are trying to outperform benchmarks.

Later in the year, portfolio managers lock in returns (and their Christmas bonus) by divesting from lesser-known, risky stocks and replacing them with well-known and less risky stocks or risk-free securities, such as government bonds. Such behaviour affects prices and security returns in a predictable way. Risky stocks and high-risk bonds are, on average, bid up early in the year and down later in the year, whereas low-risk stocks and risk-free bonds exhibit the opposite behaviour – down early in the year and up later.

All this gives rise to stock market strength from November to April – as investors not bound by the restrictions or conflicts portfolio managers are facing tend to position for the early-year rally in stocks well ahead of time. This is then followed by weakness in the May-to-October period, relative to the rest of the year. The opposite effect is seen in risk-free bonds.

Consistent with this seasonal pattern, my research also shows that the strongest quarter of the year for fund flows into stocks is the first quarter (January-March), while for Government of Canada bonds, the strongest quarter of the year is the fourth quarter (October-December).

Such seasonal behaviour in security returns is difficult for the markets to fully eliminate for two reasons.

First, it is related to window-dressing and remuneration-motivated portfolio rebalancing by professional portfolio managers who pursue their own interest year in and year out. Second, seasonality is not consistently observed every year. Unless we can anticipate seasonal behaviour on a consistent basis, market participants cannot fully arbitrage the seasonal behaviour of financial securities.

Considering the many signs of market exuberance amid economic and geopolitical risks, in conjunction with portfolio managers' conflict-of-interest-driven portfolio rebalancing, we may have a strong "sell in May and go away effect" this year.

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