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Sorry, the ‘January Barometer’ Is a Market Myth

The idea that the direction stocks take in January will be their direction for the full year isn’t supported by strict statistical analysis.

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The stock market in January has no special ability to forecast the future.

That may surprise a lot of investors, since a popular urban myth on Wall Street is that the market’s performance in January predicts which direction stock prices will take for the full year. The problem is that there is little statistical support for that belief.

According to the Stock Trader’s Almanac, this supposed pattern—variously known as the January Indicator or the January Barometer—was devised by the legendary market guru Yale Hirsch in 1972.

You don’t have to look very far to find the shortcomings of the January Barometer. You may recall that January 2016 was one of the worst Januaries for the stock market in U.S. history, with the S&P 500 index sliding more than 5%. An investor guided by the January Barometer would have gotten out of stocks in early February; at what turned out to be some of the worst prices of the entire year—and missed the more than 15% rally the market mounted from early February through the end of the year.

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A lot of pros think the recent rally in small-cap stocks is more than just postelection blip. But investors need to be selective.
In fact, the January Barometer has been right only 64% of the time since 1972. For a sense of how faulty that is, consider this: If there was a rule that simply predicted the market would go up every year, it would have been right 76% of the time over the same period.

Some January Barometer devotees nevertheless insist that its record is better than these statistics suggest. For example, Jeffrey Hirsch, Yale Hirsch’s son and editor of the Almanac Investor newsletter, reports that the Barometer has an 86.4% accuracy rate since 1950. But I believe that success rate is inflated, for a couple of reasons.

The first is that, when calculating it, Mr. Hirsch’s approach is to ignore those years in which the indicator’s failures were supposedly minor—“flat years” in which the market moved less than 5% in the opposite direction to that which was forecast. (Including those eight 3%-or-less years immediately shaves 12 percentage points off the Barometer’s performance.) The second factor inflating the Barometer’s reported success rate is including in that record’s calculations the years before its discovery in 1972.

Both of these statistical no-no’s are symptoms of an all-too-common practice known as data mining—slicing and dicing the data until they produce the desired conclusion.

The younger Mr. Hirsch nevertheless stands by the January Barometer, insisting that its record is “extraordinary.” In an interview, he argued that the indicator’s record has been particularly impressive during years in which the market rose in January. In such years since 1972, it has been right 85% of the time—better than the 76% success rate since then of a rule predicting the market would always rise.

It isn’t clear that even this improvement in success rate from 76% to 85% is statistically significant, however. That’s because of another, less obvious, form of data mining, according to Campbell Harvey, a finance professor at Duke University’s Fuqua School of Business.

In an interview, Prof. Harvey explained that before the January Barometer was “discovered,” many other hypotheses undoubtedly were explored by myriad market observers who over the years have combed through stock-market history in search of apparent seasonal patterns.

With each additional hypothesis that is explored, Prof. Harvey argues, it becomes more likely that one of them will appear to have a phenomenal record but in fact be worthless going forward. To compensate for this increased likelihood of error, he adds, it’s important to employ increasingly stringent standards of statistical significance with each additional hypothesis that is tested.

To be sure, this type of data mining isn’t unique to the January Barometer. On the contrary, Prof. Harvey—president of the American Finance Association, an organization of finance academics—said in his presidential address to the association last week in Chicago that this problem affects much of academic finance research as well. Many of the supposed patterns on which some market timers and traders base their strategies would be found to be no more than statistical flukes if their track records were properly adjusted for the data mining involved in their discoveries, Prof. Harvey said.
The best advice for most individual investors, therefore, is to buy and hold a diversified group of quality stocks—without regard to whether the stock market is up or down this month. If a correction or bear market would be intolerable, you should reduce your equity exposure now, with the stock market at or near all-time highs, rather than wait until the bottom of a decline to discover that you don’t have what it takes to hold through thick and thin.

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