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Investor Optimism, False Hopes and the January Effect

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Abstract

This paper proposes that the January Effect is at least partly explained by a behavioral framework based on optimistic expectations. The turn-of-the-year is hypothesized to be a time of renewed optimism. Indeed, investor sentiment, as measured by the University of Michigan's Index of Consumer Confidence, peaks in January. Thus, optimists are expected to bid up the stock prices of firms with higher levels of uncertainty in January. These firms will subsequently underperform as they disappoint investors during the remainder of the year. Despite the disappointment, the January pattern persists due to the “false hope syndrome” described in the psychology literature. Using forecast dispersion to proxy for uncertainty, the results are consistent with the optimism hypothesis. Similar reasoning may help explain other anomalies.

Keywords:

Notes

1. A telephone survey conducted by Opinion Research Corporation in 2006 found that more than 80% of U.S. adults responding to the survey made a New Year's resolution sometime within the previous five years. Only 15% of those surveyed never make resolutions. Harris Interactive Healthcare Surveys found that 44% of U.S. adults made health-related New Year's resolutions in 2007 and 48% made such resolutions in 2006. The success rate of the more difficult resolutions was low. For example, in 2006 only 34% of those resolving to lose weight reported success in meeting that goal. Financial goals are popular resolutions. In another survey conducted by Opinion Research Corporation in 2009, the most common resolutions for 2009 were money-related as opposed to the more traditional health-related ones. Of those making resolutions, 59% said they would start or build retirement savings, and 47% said they would start or build an investment portfolio.

2. For some recent evidence, Chen and Singal [2004] explore a variety of causes but only find support for tax loss selling. They contend window dressing is unimportant because returns in the months surrounding midyear reporting dates (June and July) are not unusual. However, Haug and Hirschey [2006] discount the value of tax loss selling by finding the January Effect still exists for small firms despite passage of the Tax Reform Act of 1986, which changed the tax period but not the reporting period. Other theories include arguments related to market microstructure (e.g., Keim [1989]), liquidity increases (Ogden [1990]), and information uncertainty risk (e.g., Kim [2006]).

3. The unadjusted file is used to avoid rounding issues related to stock splits (see Diether, Malloy, and Scherbina [2002]). While dispersion has been used or indicated as a proxy for disparity of opinion or financial distress (e.g., Diether, Malloy, and Scherbina [2002], Avramov, Chordia, Jostova, and Philipov [2009]), these other possible proxies are just as useful as information uncertainty for testing the optimism hypothesis. For example, investors may feel more optimistic toward distressed firms in January.

4. Two empirical issues are worthy of note. First, prior studies show that dispersion and optimism decrease as the fiscal year progresses (e.g., Richardson, Teoh, and Wysocki [2004]). However, because dispersion is computed monthly and the testing is performed monthly, any biases or trends are largely standardized across all observations in that month. There is still variation across reporting dates, but a robustness check including only firms with December 31 fiscal year-ends resolves this issue (see Table 6). Second, individual forecast dispersion, not individual forecast optimism, is relevant. In the context of this study, when dispersion is high, optimists exist and drive stock prices regardless of whether or not the consensus forecast is eventually revealed to be optimistic.

5. Although standard practice, using the logarithm of BE/ME eliminates firms with negative book-to-market ratios and therefore reduces the sample size for the regression model testing by about 5% versus the portfolio analysis. As a robustness check, the regressions are specified using BE/ME instead of log(BE/ME), which strengthens the conclusions.

6. The larger average size of firms covered by IBES and the relative dearth of micro-cap stocks eliminate the need to sort firms into size portfolios based on New York Stock Exchange breakpoints.

7. The correlations, however, are not problematically high: Disp and log(ME) is −0.16, Disp and Mom -12,-1 is −0.08, and Disp and log(BE/ME) is 0.15.

8. Although the coefficients of Disp in January are significant at the 10% level, this level is perhaps impressive when considering the small number of degrees of freedom (25).

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