WEALTH BUILDING

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Should investors expect a Santa Claus rally?

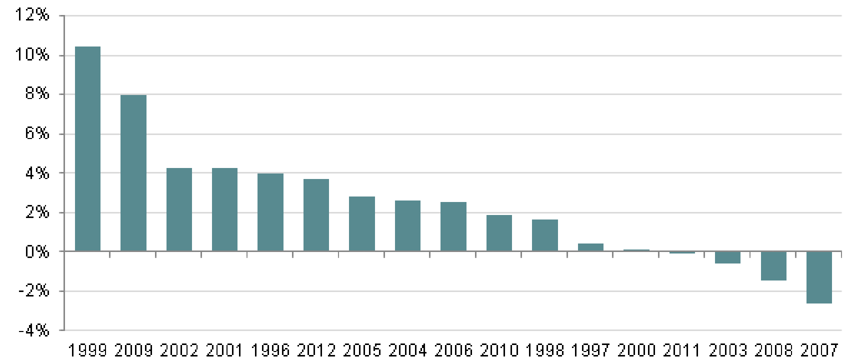
If the statistics are anything to go by we can expect equity markets to perform strongly over December.

The December Effect, The January Effect, Sell in May and Go Away, the Halloween Indicator and the Santa Claus Rally. Stock market folklore and academic literature are populated with such maxims telling you when to invest or not invest in the stock market. A popular one relates to equity markets performing strongly over the December and January period, with reasons ranging from tax considerations to window dressing by fund managers, to investors putting their year-end bonus into the stock market.

So should investors expect a Santa Claus Rally in equity markets at the end of the year? And if so should they position themselves for it? Surprisingly this is one rule of thumb that is well supported by the statistics. There are a number of published papers showing that this seasonal effect has been strong and consistent over time and different geographies. If one looks at South African equity returns over December since 1960 the seasonality effect is quite strong and consistent, as shown in the graph below. Not only does December average higher returns than the full year average, it also has a higher probability of generating a positive return.

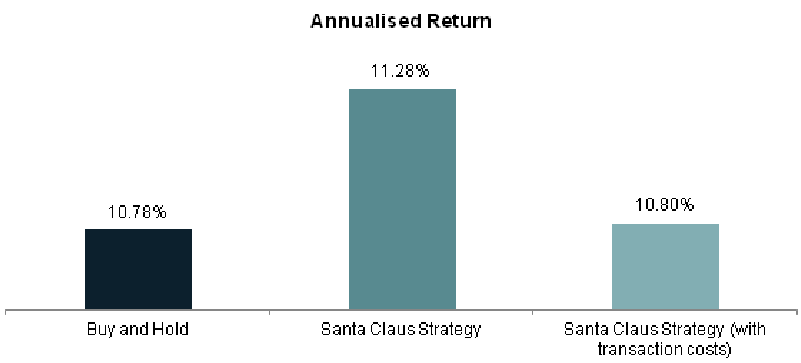
1960 - 2012	Full Year	December
Average Monthly Return	1.5%	3.7%
Annualised Volatility	21.2%	20.2%
% Positive Months	62.7%	71.2%

If we take a narrower look at the specific holiday period over the end of the year, by taking the last 10 trading days of the year along with the first five trading days of the new year, we see that over the past 17 periods since 1996, the market was up 75% of the time or 13/17 periods and on average returned 2.46% over this short period. See the graph below.



Obviously this raises the question, how can one benefit from this effect? Could an investor who observed this pattern in 1996 have exploited it as a profitable trading strategy over the past 17 years? If we run a simple test of a portfolio that normally invests 60% in equity and 40% in cash but ups the equity weighting to 100% during the holiday period, would this have outperformed a buy and hold investor merely holding 60% equity and 40% cash? On the face of it the answer is yes. A simple test of this strategy shows that the 'Santa Claus' strategy would have returned an average 11.28% per annum versus a return of 10.78% over the 17 years.

However, unfortunately in real life there is a cost to switching a portfolio's asset allocation. The stockbroker you would have to call back to the office from Plett or Margate to buy your Santa stocks on the 20th of December will charge you brokerage costs. If we take these brokerage costs into account in our simulation the advantage of this strategy all but disappears. Assuming a 0.5% total transaction cost, the return on the Santa strategy drops to an annualised 10.80%, a mere 0.02% per annum higher than the buy and hold strategy. See the graph below.



So, while the Santa Claus Rally sounds appealing, you may be better off taking a break over the end of the year and relying on long term investing to generate your returns.

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