



# Is the January effect rational? Insights from the accounting valuation model



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## ABSTRACT

Employing a permanent earnings valuation model and a novel sample partition, we find evidence that the January effect “anomaly” is consistent with rational economic market behavior. Investors in firms which experience January effect return premiums appear to discount first quarter earnings performance but reward permanent earnings and expectations of future improvements. Our evidence also supports a tax-loss selling explanation for the January effect. We find that the January effect is experienced by relatively few firms in the sample overall, but a substantial percentage of January effect firms are identified as potential tax-loss sellers. Our results complement prior research suggesting that the January effect is neither a result of irrational noise traders nor consistent with systemic risk factor explanations. Our study reconciles the assumption of arbitrage inherent in trading studies with a fundamental accounting valuation approach and offers some further insights into the nature of this market phenomenon.

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## 1. Introduction

This paper finds that the January effect anomaly is associated with accounting earnings and expectations about future earnings, in a manner both economically rational and consistent with accounting theory. This work extends that of [Henker and Debapriya \(2012\)](#), who argue against an “irrational noise trader” explanation for the January effect. It complements that of [Klein and Rosenfeld \(1991\)](#), who present evidence that the January effect can be explained at least in part by new information in January about upcoming earnings announcements. Finally, our accounting valuation approach complements [Mashruwala and Mashruwala \(2011\)](#), who argue that return seasonality is incompatible with systemic risk explanations.

[Fama \(1998\)](#) and [Gerlach \(2007, 2010\)](#) both argue that many so-called market anomalies are tenuous in the sense that they are sensitive to the methodologies used to detect or measure them. Far from being tenuous, the January effect – a capital markets

phenomenon in which return premiums are on average higher in January than in other months of the year<sup>1</sup> – persists in defiance of economic theory which says it should be arbitrated away. Although some studies suggest that the January effect is disappearing ([Gu, 2003](#); [He & He, 2011](#); [Hensel & Ziemba, 2000](#); [Mehdian & Perry, 2002](#)), numerous others provide evidence that the January effect continues to appear in modern US capital markets ([Anderson, Gerlach, & DiTraglia, 2007](#); [Brown & Luo, 2006](#); [Ciccione, 2011](#); [Dzhabarov & Ziemba, 2010](#); [Easterday, Sen, & Stephan, 2009](#); [Haug & Hirschey, 2006](#); [Mashruwala & Mashruwala, 2011](#); [Ziemba, 2011](#)) although it does not occur every year ([Easterday et al., 2009](#); [Hulbert, 2008](#)).

Tax management is the most common rationalization for the January effect: investors take advantage of capital losses at year end for tax purposes, resulting in temporary downward mispricings that create large January returns when prices rebound after the turn of the year ([Branch, 1977](#); [Brown, Ferguson, & Sherry, 2010](#); [Chen & Singal, 2004](#); [Dalton, 1993](#); [Givoly & Ovadia, 1983](#); [Griffiths & White, 1993](#); [Grinblatt & Keloharju, 2004](#); [Jones, Lee, & Apenbrink, 1991](#); [Koogler & Maberly, 1994](#); [Ma, Rao, & Weinraub, 1988](#); [Phua, Chan, Faff, & Hudson, 2010](#); [Sikes, 2014](#); [Starks, Yong,](#)

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<sup>1</sup> Some researchers call it the “turn of the year effect.” Both terms are widely used throughout the literature, often interchangeably.

& Zheng, 2006).<sup>2</sup> However, there is evidence that tax minimizing behavior by itself is not enough to drive the January effect (Brown, Keim, Kleidon, & Marsh, 1983; Fountas & Segredakis, 2002; Jones & Wilson, 1989; Pettingill, 1989; Reinganum, 1983; Ritter, 1988; Sias & Starks, 1997; van den Bergh & Wessels, 1985).

Rather than attempting to explain the January effect, Mashruwala and Mashruwala (2011) exploit this seasonal increase in stock prices to examine whether accruals quality measures proxy for information risk. Their findings suggest that such measures proxy more for firm attributes associated with tax-loss selling than for information risk. Studies by Brauer and Chang (1990), Peterson (1990), and Reinganum and Gangopadhyay (1991) also provide evidence that information risk is not related to the January effect.

Extant research into the January effect itself appears primarily in the finance literature where it is often explained as a temporary mispricing anomaly resulting from various market inefficiencies and risks resulting in arbitrage opportunities. However, some studies (Loughran, 1997; Mashruwala & Mashruwala, 2011; Roll, 1983; Seyhun, 1993; Tinic & West, 1984) argue that systemic risk factor explanations are not compatible with seasonal market behaviors. A recent study by Henker and Debapriya (2012) provides evidence that the January effect is not driven by irrational noise traders. CAPM models neither predict nor explain risk, especially (or only) in January (Best, Hodges, & Yoder, 2006; Corhay, Hawawini, & Michel, 1987; Gultekin & Gultekin, 1987; Kryzanowski & Zhang, 1992; Ritter & Chopra, 1989; Thaler, 1987).

Insights from the fundamental valuation theory of accounting suggest that under a no arbitrage condition, returns in January – or any time period – should be positively associated with contemporaneous accounting earnings and information affecting expectations about future accounting performance (Feltham & Ohlson, 1995; Ohlson, 1995, 2001). With the exception of Klein and Rosenfeld (1991) there is little research considering how – or whether – the January effect anomaly is associated with accounting earnings information in a market-efficient, rational economic manner.<sup>3</sup> Their evidence shows that low-PE stocks with low annual earnings forecasts in December outperform in January relative to other low-PE stocks and they argue that the prices of these stocks rise in January because it becomes apparent to investors then that actual earnings for the just-completed year will be better than was forecasted in December. Their analyses employ a trailing-earnings-to-price ratio and focus on earnings forecasts and investors' expectations for the earnings announcement for the year immediately past.

We extend Klein and Rosenfeld (1991) by employing a form of the permanent earnings model developed in Easterday, Sen, and Stephan (2011)<sup>4</sup> to examine the association between January returns and earnings in the first quarter. The ESS model expresses returns as a function of contemporaneous earnings level, earnings growth, and a term representing the sustainability of earnings growth, and the model derives directly from Ohlson's (1995, 2001) valuation framework. Employing an accounting valuation model rather than an ad hoc trading model enables us to forgo an assumption of arbitrage and demonstrate that, consistent with economic and accounting theory, earnings information plays an important role in the economic intuition of the January effect phenomenon.

Our model is consistent with the notions that (1) earnings change – not earnings level – captures the permanent component of earnings (Ali & Zarowin, 1992; Ohlson & Shroff, 1992); and (2) information about future earnings is essential to valuation because it adjusts for transitory components of current earnings. Valuation depends critically on permanent earnings (Pan, 2007), as well as the expectation that permanent earnings will be sustained into the future. In addition, eschewing a CAPM approach avoids the uncertainties inherent in estimating required rates of return, a feature of valuation based on asset pricing models.<sup>5</sup>

In order to examine the association of these anomalous returns with accounting earnings information we introduce an innovative sample partition, forming an *ex post* categorization of firms that experience the January effect (JE firms) versus those that do not (NJE firms).<sup>6</sup> Thus, we specifically identify firms that exhibit January effect return premiums rather than relying on some firm characteristic(s) presumed to be associated with the January effect. NJE firms act as a kind of comparison group; but under our model and approach, evidence of rational economic behavior in one group does not negate or preclude rational economic behavior in the other.

We find that JE firms represent approximately nine percent of all firms in our sample and range across all market caps, suggesting that the January effect is driven by relatively few firms overall and is frequently but not exclusively a small firm phenomenon. Our JE/NJE partition delivers some intriguing results when implemented in our valuation model.

For JE firms the coefficient on first quarter contemporaneous earnings level is significantly negative, while the coefficients for contemporaneous earnings growth and expectations for future earnings growth remain significantly positive. Although a negative earnings level coefficient may seem at first irrational, it may indeed be consistent with rational behavior. First and most importantly, our valuation model is more comprehensive in that it does not rely only on current or past earnings information, but includes all other information as captured by the construction of the analysts' forecast variable. The inclusion of the term for information about expected future earnings captures the reality that market decisions are based in large part on expectations for the future.

Second, it is well established that price leads earnings (Ball & Brown, 1968; Beaver, Lambert, & Morse, 1980; Beaver, Lambert, & Ryan, 1987; Collins, Kothari, Shanken, & Sloan, 1994; DeBondt & Thaler, 1985, 1987; Kothari, 2001). We contend that poor year end returns followed by superior January returns foreshadow poor first quarter earnings followed by an earnings improvement. Our examination of earnings for the quarters immediately preceding and following the first quarter, as well as a correlation analysis of sequential quarterly earnings, both support this contention. These results are also compatible with those of Beaver et al. (1980) and DeBondt and Thaler (1987).<sup>7</sup>

Third, we argue that permanent earnings and their sustainability should be quite relevant to higher return premiums in January, a proposal in keeping with the tax-loss trading explanation for the January effect advanced in so many prior studies. Firms are

<sup>2</sup> Additional studies focus on the January effect and its relation to tax rules for individual and institutional investors (Lynch, Puckett, & Yan, 2014; Poterba and Weisbenner, 2001; Slemrod, 1982).

<sup>3</sup> Lakonishok, Shleifer, and Vishny (1994) include current P/E ratio as one indicator of possible mispricing but their study does not examine fundamental valuation implications of accounting earnings.

<sup>4</sup> Hereafter, ESS.

<sup>5</sup> Penman (2004, p. 96) reminds us that a capital asset pricing model (CAPM) generates a required rate of return, not asset value. Further, valuation models relying on estimated rates of return can be highly sensitive to the underlying assumptions used in the CAPM.

<sup>6</sup> If a firm's January return premium is the highest of all 12 months of the year then it is classified as a "JE" firm for that year. Otherwise, the firm is categorized as "NJE."

<sup>7</sup> Beaver et al. (1980) demonstrate that returns are positively associated with earnings of the following period. DeBondt and Thaler (1987) present evidence that earnings improve in subsequent periods for loser firms. They also observe that January and December return premiums are negatively associated.

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