The January Effect is Here Early

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The "January Effect" refers to the tendency for small caps to underperform large caps for most of the year until November when they begin to rally. By mid-December, they soar. Looking at November index returns confirms this fact with the small-cap Russell 2000 index gaining more than 18% compared to the 11%$^+$ gain in the Russell 1000 index. Micro-cap stocks rallied by more than 20%! So far this month, the Russell 2000 is up by 4% compared to a gain of less than 1% for the Russell 1000 index. Some market pundits attribute this year-end spurt in small caps to investors who want to capitalize on anticipated gains early next year.

The Russell 2000 versus the Russell 1000 index returns from 1979 demonstrates that smaller companies had the upper hand for five years through 1983. After falling behind for about eight years, small caps came back after the Persian Gulf War bottom in 1990, moving up until 1994 when large-cap stocks ruled the latter stages of the millennial bull market. For the next six years, the picture was bleak for the "little guys" as both blue chips and the large tech behemoths moved to stratospheric highs. In late 1999 and early 2000, small caps spiked and reached a peak early in 2006 as the 4-year-old bull market entered its final year.

The most important point in this historical analysis is that small-cap returns can be more volatile in the short term. More recently in the year ending December 2018, a small-cap portfolio would have lost more than 11%, compared to a large-cap portfolio loss of nearly 5%. Over the previous 20 years, however, small caps returned nearly 9% compared to the return of 6% for large cap stocks. And since 1926, a small-cap portfolio would have returned 11.6% compared to a 9.8% return for large-cap stocks. While this difference appears marginal, over long time periods the difference can produce a substantial difference in a portfolio's value.

One lesson is that investing in large-cap versus small-cap stocks depends on an investor's appetite for risk and their time horizon. Small-cap stocks are a riskier investment, but if an investor has decades until retirement, they can probably weather some market swings. Many financial planners suggest putting about 5% to 15% in small-cap stocks.

Another lesson is that diversification by market capitalization can dampen the short-term risks of one index underperforming. This latest example demonstrates that a big bet on large cap stocks in the last two months would have missed the stellar performance of the little guys.