A January Effect for Large-Cap Stocks?

The January effect is the tendency of low price, small-capitalization stocks to outperform in January. Historically, these are stocks that were sold for tax reasons late in the prior calendar year and repurchased the following January because investors still think the stocks are fundamentally attractive. Since individual investors using this strategy must wait 30 days before repurchasing any stock sold at a loss to avoid triggering the wash sale rule, these stocks can decline in December and rise in January. The wash sale prevents a loss from being realized if a substantially identical security is repurchased within 30 days of a sale.

Due to the uncertainty about 2013 tax rates, it is possible that we are seeing some stocks getting set up for a large-cap version of the January effect. In this case, the selling pressure could be coming from investors wanting to realize long-term gains at the known tax rate of 15%, rather than risk a potentially higher tax rate in 2013. Individual investors who sell a stock to realize a capital gain can repurchase the stock immediately and reset their cost basis to a higher level. They must wait 30 days to repurchase the stock, however, if they want the flexibility of writing off a potential loss on the new position.

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