December 3, 2018

Market Ethos

The latest market insights from the Richardson GMP team

RICHARDSON GMP

The Biggest Loser

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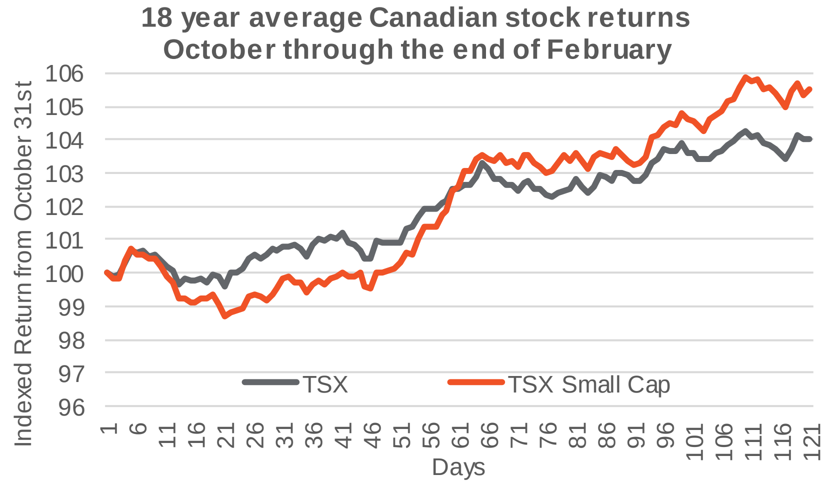
Along with some early holiday shopping, astute investors also get busy in November selling off the 'dogs' in their portfolio. Ben Franklin might have been right when he said that "in this world, nothing can be said to be certain, except death and taxes." However, advance tax planning now can certainly help minimize your capital gains tax come April, as long as you sell your stocks before or on December 27. (Canadian stocks sold after that date carry their capital losses forward to the 2019 taxation year.) Depending on your returns for the year, your portfolios may have a few or several worthy candidates to sell off and crystallize the losses, and hopefully offset some gains in other positions.

The annual tax-loss selling tradition has a seasonal effect on the underlying index. We looked back eighteen years at the TSX and TSX Small Cap Index and identified a prevalent pattern. As demonstrated in the chart below, markets on average tend to face increased selling pressure in November, driving indices lower. The selling pressure tends to abate midway through December, triggering a noticeable seasonal increase in stock prices during the new year. This effect has been well-studied and is aptly called the 'January effect.' While not a bias itself, this seasonal aspect of the market is certainly rooted in investor psychology.



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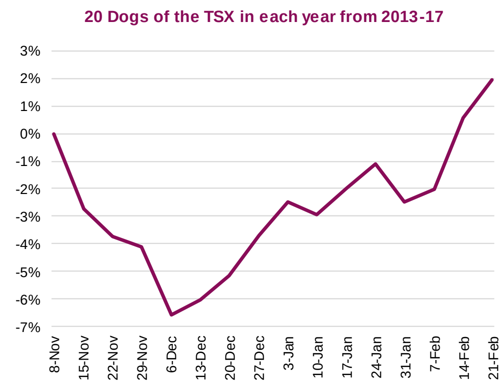
The January effect seems to affect small caps more than large caps, likely because they are less liquid. You can see from the chart that the TSX Small Cap Index experienced a larger sell-off in the tax-loss selling period and still managed to outperform the S&P/TSX Composite Index by the end of February. Tax-loss selling isn't the only behavioural reason for this effect. In January, investors could also be putting cash bonuses into the market or perhaps buying their favorite Purpose fund. There may also be some window-dressing, as institutional fund managers shed losers to improve the appearance of their year-end holdings. It's purely cosmetic in nature but does add to the pressure for the year's biggest losers.



Dogs of the TSX

We did some data-sleuthing to demonstrate this effect. For each of the past five years (2013-2017), we created a basket of the 20 worst performers on the TSX, as of November 1. We then measured their median performance from November to February. As these are the positions that fell the most during the year, they are likely at risk of "tax-loss selling." As you can see from the chart, selling pressure was strong in November and began to abate in mid-December, turning into strong gains heading into the new year.

Behavioural investing, in our opinion, moves beyond simply looking at individual company or market fundamentals to incorporate the behavior of other market participants. If you know there are going to be a bunch of sellers in the market for tax reasons, this gives you an advantage. In a highly competitive market, advantages are hard to come by and can be key to your success.

Charts are sourced to Bloomberg unless otherwise noted.