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Should You Really Sell in May and Go Away?

It's that time of year again, when the stock trading adage "Sell in May and Go Away" reemerges and its merits are debated. The phrase refers to the long-standing cycle of seasonal strength and weakness not only for U.S. stocks, but for international and emerging markets indexes as well. Should investors heed the call and follow this market timing strategy?

Instead of retreating from stocks entirely, investors may be better advised to identify more attractive areas within the universe of stocks to invest in during this seasonally slow period.

Tracing the Seasonality of Stocks

Since 1945 the S&P 500 has posted its strongest six-month average return from November 1 through April 30, recording an advance of 6.9% (excluding dividends) versus an average gain of 4.1% for all months. Yet from May through October, the S&P 500 has gone through a pronounced "seasonal slump," rising only 1.2%.[1]

Notably, these seasonal tendencies have been in evidence regardless of the size or geography of stocks. For instance, since 1990, the S&P MidCap 400 has gained an average 9.8% from November through April, but only 2.0% from May through October. A similar pattern of performance has occurred within the S&P SmallCap 600 since 1995 and in the leading international indexes -- the MSCI-EAFE and MSCI-Emerging Markets since 1970 and 1988 respectively.[1]

Making Sense of Seasonality

What is behind this seasonal pattern of performance? S&P Capital IQ's Chief Equity Strategist Sam Stovall offers some practical observations.

- Capital Inflows -- The above-average strength of stocks in the November-April stretch may be aided by large cash infusions into the market, particularly during the beginning of each calendar year. Pension plans typically make large contributions early in the year. Bonuses and tax refunds are typically paid out in the first few months of the calendar year, and could potentially end up invested in the market soon thereafter. In addition, IRA contributions are due by April 15 each year.

- Vacations -- Since 1945 the S&P 500 has posted its weakest average three-month performance of 0.5% in the third quarter each year (versus 2.2% for Q1, 1.8% for Q2, and 3.7% for Q4), as investors' attention may be focused more on summer vacation getaways than on the return on their stock portfolios.

- Earnings -- End-of-year earnings revisions also may contribute to the market's poor performance in the third quarter. Investors may be forgiving of soft Q1 and Q2 earnings as they look ahead to solid full-year estimates. Yet if Q3 performance estimates are also under par, investors may be more likely to sell to cut losses. As a result, this could help explain why September has historically been the worst performing month of the year. What's more, 5 of the 10 bear markets since World War II ended in October.[1]

- Mutual Fund Sell-Offs -- Mutual funds publish quarterly holdings. As a result, they typically engage in end-of-quarter "window dressing," meaning that they sell their underperformers so as not to appear to be holding losing stocks. And since many funds have fiscal years ending in October, they engage in an even more thorough portfolio pruning in the final quarter of their calendar year, possibly adding to this overall seasonal pressure.

Rotate, Don't Retreat

While it may be interesting to gain a better understanding of this statistical phenomenon, the question remains, should investors really embrace the "sell in May and go away" mantra? Market strategists at S&P Capital IQ think not. "The average advance of 1.2% for the S&P 500 since 1945 is still better that what an investor could earn in a money market account," observed S&P's Stovall. In addition, by sitting on the sidelines, investors run the risk of missing out on summertime surges in stock prices. For example, during 2009, 2003, and 1997 the S&P 500 gained 14% or more in the May to October time frame.[1]

Instead of retreating from stocks entirely, investors may be better advised to identify more attractive areas within the universe of stocks to invest in during this seasonally slow period. For instance, since 1990, some defensive sectors within the S&P 500, namely Consumer Staples and Health Care, have posted average price gains of 4.6% and 4.4%, respectively, during the summer months when the overall S&P 500 was eking out a rise of 1.0%.[1]

And just as the seasonality in leading equity benchmarks has persisted over time regardless of size or region, a semiannual sector rotation strategy has outperformed a buy-and-hold approach over time, whether you track the cap- or equal-weighted S&P 500, the SmallCap 600, or the Global 1200.[1]

So, should you believe the market faces a challenging period ahead, you may want to consider a semiannual sector rotation strategy. Before doing so, however, be sure to consult with your financial advisor to determine whether sector rotation is an appropriate strategy for your particular situation.

[1]Source: Standard & Poor's Capital IQ, *Global Equity Research*, "Sell in May and Go … Where?" April 22, 2013. Past performance is not a guarantee of future results.