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The Improbable Success of Seasonality Trading

When it comes to active investment strategies, one of the most fascinating - if simply because it worked for many years - is seasonality trading. Seasonality trading is based on the premise that there are good days and bad days to be invested and these days can be identified by looking at historical patterns.

The Halloween Indicator is based on the historical tendency for the stock market to produce almost all of its net returns between Halloween and the May Day (a variation of sell in May and go away). The holiday effect reflects the historical tendency for stocks to rise in the two or three trading days before a market holiday, such as the 4th of July or Christmas. The five trading days prior to St. Patrick's Day have historically proven a good time to be invested. Stocks also tend to perform better during the middle of the month.

How can such simple systems work? Wharton University Professor Donald Keim asked the same question and confirmed that there are distinct calendar-based patterns to how stocks trade. Some of the factors that may contribute to this are the timing of periodic retirement plan contributions, tax-loss selling, and short-term traders' reluctance to be exposed to stocks over a long holiday weekend.

In the early 1970s, Norman Fosback came out with his Seasonality Trading System, which was later dubbed by Mark Hulbert as the best market timing system he had encountered in years of tracking active managers. The only thing an investor needed to know was what day of the month it was.

In *"Timing System Gone, Not Forgotten"* from 2003, Mark Hulbert listed Norman Fosback's past timing system rules:

- Buy at the close of the third-to-last trading of each month, and sell at the close of the fifth trading session of the following month.
- Buy at the close of the third-to-last trading day prior to exchange holidays, and sell at the close of the last trading day before a holiday.
- Exceptions: If the holiday falls on a Thursday, sell at Friday's close rather than Wednesday's. Also, if the last day before a holiday is the first trading day of the week, don't sell until the day after the holiday. Finally, never sell on the first trading day after options expire; instead wait an extra day.

Naturally there are drawbacks. Fosback's system requires a lot of trading and trading costs must be kept to a minimum to avoid eating away potential gains. Not every trade will be profitable. Popularity of the system at its height eroded its potential to produce gains due to a phenomenon known as the "crowded trade."

To use seasonality systems over the long run, the investor needs to have the confidence to stick with it and overcome the psychological difficulty of spending a substantial time in cash when the market may be making new gains.

Even the most accurate seasonality trend will always be vulnerable to extreme market action, however. Trading based on the day of the month can't protect a portfolio from losses or assure gains. But it is an interesting look at how human behavior follows patterns over the years.

Trend or Noise?

"To be a successful investor over the long run, you must adapt to the belief that you cannot predict the market. You must use tools that remove your emotions from the decision-making process."
Greg Morris, Technical Analyst and Author

One of the most important and hardest lessons for an investor to learn is to distinguish noise from information. With a proliferation of news sources from newspapers and broadcast media to financial publications, blogs, and social platforms, we are constantly bombarded with vast quantities of diverse market and economic information. The current emphasis on content marketing is adding to the over saturation with every financial professional contributing his daily or weekly wisdom to the overflow. The truth is very little of this information is useful when it comes to making investment decisions.

Media "experts" have a very poor track record of calling market direction. Because "bad news sells," the media's focus is overwhelmingly on doom and gloom. On election day 2016, the U.S. stock market fell 5% sparked purely by fears fed by media noise. Investors who bought into the noise missed the market's subsequent run to new highs.

The market trend is the truth that merits our attention. The noise distracts us from the truth and replaces a systematic approach to the markets with emotion.

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