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Summary of "The Pre-FOMC Announcement Drift"[1]

Members of the FOMC, the Federal Reserve's policy-making body, regularly convene at scheduled meetings to make monetary policy decisions. These FOMC meetings have taken place eight times per year since the early 1980s, and were scheduled much more frequently before then. The FOMC announcements contain significant information about monetary policy and systematic risks.

While it is common for FOMC members to provide monetary policy information through speeches and interviews between meetings, they refrain from these discussions in the week *before* FOMC meetings (a time interval known as the "blackout period"). Without news on systematic risks, we should not expect significant pre-announcement stock returns, particularly given that the pre-announcement window does not overlap with other macro announcements.

Surprisingly, this paper documents that since 1994, the S&P500 index (SPX) has on average increased 49 basis points in the 24 hours before scheduled FOMC announcements. In contrast, the average cumulative SPX return is only 0.5 basis points on average in the other 24-hour windows.[2] As a result, about 80% of annual realized excess stock returns are accounted for by this pre-FOMC announcement drift. The volatility of index return is similar in the pre-FOMC windows and other times. A simple strategy that consists of buying the index at 2 pm the day before a scheduled FOMC announcement, selling fifteen minutes before the announcement and holding cash on all other times would have earned a large annualized Sharpe ratio of 1.14 from 1994 to 2011. The findings are robust to small sample and data snooping concerns examined by the authors, and remain statistically significant after dropping the top and bottom 1% returns.

The pre-FOMC returns tend to be higher when investors expect the Fed to ease its stance of monetary policy (proxied by the decrease of the yield curve slope), when implied equity market volatility (VIX) is high, and when past pre-FOMC returns have been positive.

The authors also explore the cross-section properties of pre-FOMC announcement drift. The market beta explains more than 60% of the cross-sectional dispersion of returns on FOMC days across size- and industry-sorted portfolios.[3] This confirms that the pre-FOMC announcement drift is a market-wide phenomenon and can hardly be explained by disproportionally redistributive effects of monetary policy across sectors and on firms of different scales. The index returns in most foreign stock markets (except Japan) also exhibit pre-FOMC announcement drift, but after replacing the FOMC announcements with the corresponding local central banks' announcements, the authors do not find any pre-announcement abnormal cumulative return.

Interestingly, pre-FOMC announcement drifts are not identified among the fixed income instruments, such as Treasury securities and interest rate futures, where we expect monetary policy yields the most direct influence. The authors find that SPX does not feature abnormal excess returns ahead of other major macroeconomic announcements, such as total nonfarm payroll employment, weekly initial claims for unemployment insurance, and CPI.

The authors discuss a number of potential driving forces behind pre-FOMC returns ranging from higher systematic risk and its reallocation among investors, to unexpected positive news before announcements, liquidity or volatility. It is difficult to square these explanations with all of the empirical evidence.

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[1] Lucca, David O., and Emanuel Moench, 2013, *Journal of Finance* Forthcoming.

[2] Starting in 1994 the decisions of scheduled meetings have been announced to the public within a few minutes of 2:15 pm EST. The pre-announcement window is defined as from 2PM of the day before to 2PM of the announcement day. Prior to 1994, monetary policy decisions were not announced, and investors had to indirectly infer policy actions through the size and type of open market operations in the days following each meeting. Thus, prior to 1994, the authors consider as pre-FOMC returns those earned on days of scheduled FOMC meetings, which mark the last trading session before investors could observe signals about policy decisions. From 1980 to 1993, the pre-FOMC drift is on average 20 basis points, so combining the samples before and after 1994, about half of the realized excess stock market returns were earned during the pre-FOMC window between January 1980 and March 2011. Over this 30-year period and the simple strategy of holding stocks only right ahead of FOMC announcements and cash otherwise would have delivered an annualized Sharpe ratio of 0.92. There is no evidence of pre-FOMC returns before 1980.

[3] Due to the limited intraday information on individual stocks, the authors use close-to-close daily returns of the FOMC days in place from the 2pm-to-2pm return. Small firms and firms in agriculture and food feature smaller and insignificant FOMC day returns.