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Red and blue investing: Values and finance ☆

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Abstract

Using data on the political contributions and stock holdings of U.S. investment managers, we find that mutual fund managers who make campaign donations to Democrats hold less of their portfolios (relative to non-donors or Republican donors) in companies that are deemed socially irresponsible (e.g., tobacco, guns, or defense firms or companies with bad employee relations or diversity records). Although explicit socially responsible investing (SRI) funds are more likely to be managed by Democratic managers, this result holds for non-SRI funds and after controlling for other fund and manager characteristics. The effect is more than one-half of the underweighting observed for SRI funds.

Introduction

Do political values influence investing? This is an interesting and important question for a number of reasons. First, we still have a limited understanding of where investors get their ideas and why their opinions appear to differ so greatly. Some exceptions are the growing literatures on the familiarity or local bias of investors (Tesar and Werner, 1995, French and Poterba, 1991, Huberman, 2001), information transmission through friends (Pound and Shiller, 1989, Hong et al., 2005) and differences of opinion among investors (Hong and Stein, 2003). The role of values in general—and political values in particular in shaping investments has been underexplored. Important exceptions examining how values might affect investments include Grinblatt and Keloharju (2001), Morse and Shive (2010), and Bhattacharya and Groznik (2008).

Second, the question of political biases in investing is natural in light of anecdotal evidence of major differences between Republicans and Democrats. This evidence suggests that Democrats, in contrast to Republicans, are more apt to support causes such as environmental and labor protection while opposing smoking, guns, and defense.[1] As a result, it is interesting to investigate whether Democrats underweight “socially irresponsible” companies while overweighting “socially responsible” ones. One possible reason for such portfolio decisions is that investors might derive utility from avoiding companies that are in conflict with their values. They might not want to see their savings invested in causes that they oppose, similar to a boycott of certain consumer products. An alternative, pecuniary-based explanation is that political values shape investors' risk-return models, i.e., investors might think that companies inconsistent with their values will also be less profitable or more risky in the future.

Third, the issue of political values and investing is particularly relevant in light of the growing importance of socially responsible investing (SRI). SRI has its roots in the screening of religious or moral vices (gaming, alcohol, and tobacco) from portfolios. But it has grown to encompass broader environmental and social issues such as labor standards and the manufacture of military weapons. The Social Investment Forum estimates that nearly one out of every nine dollars under professional management in the United States today is involved in SRI, or roughly 11 percent of the $25.1 trillion in total assets under management tracked in Nelson's Directory of Investment Managers. Projections indicate that SRI is likely to grow significantly over the next decade.[2]

Still, we know little about the trend toward SRI. For instance, we know that institutional ownership of “sin” stocks, particularly among endowments and universities but also among mutual funds and hedge funds, is lower relative to other stocks (Hong and Kacperczyk, 2007). Ownership of sin stocks tends to be dispersed among individual investors. But we do not know why that is the case. It might simply be that institutions want to avoid the hassle of owning socially irresponsible stocks to the extent that such stocks face more litigation risk or bad press. But anecdotal evidence suggests that political values are also likely to be at play, with institutions such as CalPERS seeming to have an institutional activist (Democratic-leaning) agenda (Barber, 2007)). Some SRI funds are simply marketed as investments that take values into account. Others, such as Generation Partners, an SRI hedge fund started by Democrats Al Gore and David Blood, argue that investing in socially responsible companies is also good for profits because these companies will be better able to adapt to changes in long-term environmental and business conditions.

In this paper, we look at how political values influence the investments of money managers, and in the process we provide new insights on a host of important issues. We investigate this question using data on the political contributions and stock holdings of U.S. mutual fund and hedge fund managers. Our basic hypothesis is that managers who donate to Democratic candidates are more likely to tilt their holdings away from (toward) socially irresponsible (responsible) stocks compared with non-donors or Republican donors. The null hypothesis is that political values have no explanatory value in predicting investments, perhaps because mutual funds uniformly underweight socially irresponsible stocks to avoid litigation risk or scrutiny.

For the most part, we are agnostic about how values influence investments, although we provide some discussion and analysis on this question. As mentioned earlier, either pecuniary or non-pecuniary reasons (or both) could be at play. On the pecuniary side, Democratic and Republican managers could differ in their opinions about socially responsible stocks because their different values shape their models of the world. On the non-pecuniary side, managers might be using their portfolio choices as a form of perk, as in classic principal-agent models (Jensen and Meckling, 1976). They might tilt toward stocks that conform with their political views if the social responsibility of stockholdings enters their utility functions.[3]

We construct a unique database from 1992 through 2006 that links the political contributions and stockholdings of a large sample of U.S. mutual fund managers. Our main independent variable is the level of political contributions of mutual fund managers, which we obtain from the Federal Election

Committee (FEC) website. Democrats are defined as those managers with net positive contributions for federal Democratic candidates, and similarly for Republicans. Managers who have not donated to members of either party are defined as non-donors.

Our main dependent variables are derived from fund portfolio holdings. We consider two measures of social responsibility. The first measure uses the lines of business or industries that SRI funds usually screen on: tobacco, alcohol, gaming, guns, defense, natural resources, nuclear power, adult entertainment, contraceptives, and abortion (for standard reference, see Geczy, Levin, and Stambaugh, 2003, or the Kinder, Lydenberg, Domini, & Co. list of controversial businesses). Our main analysis focuses on a subset of these industries: tobacco, guns and defense, and natural resources, which we label *politically sensitive industries* (*PSI*). We exclude vices such as alcohol and gaming from *PSI* since they are objectionable for religious or ethical reasons, making predictions along political lines less clear. We exclude the other "controversial" industries because of data limitations; however, our main results are unchanged when we include hand-collected data on these businesses.

The second measure is a commercially available score of corporate social responsibility provided by Kinder, Lydenberg, Domini, & Co. (KLD). The KLD ratings are built on a point-by-point assessment of companies along a number of dimensions other than controversial lines of business. We focus on ratings in four of the KLD categories: community activities, diversity, employee relations, and environmental record, which seem the most obviously sensitive to political values. Data on the other KLD categories (products, human rights, and corporate governance) are more limited. Nonetheless, in robustness checks, we show that our results hold even when we consider all seven categories.

We find strong evidence that political values influence the investment decisions of mutual fund managers. We first look at whether managers of different parties have different weights on politically sensitive industries. We find that Democratic mutual fund managers invest 2.82% of their assets in these industries while Republican managers invest 3.75%, a difference of about one percentage point. Because industry weights are correlated with fund style, we then adjust each manager's holdings in politically sensitive industries by the fund's style, which is defined by the value-weighted mean size and value (book-to-market) characteristics across all the fund's holdings (as in Daniel, Grinblatt, Titman, and Wermers, 1997), and we focus on the *residual* holdings in PSI. This ensures that our results are not an artifact of variations in fund style.

We find that a typical "strong" Democrat holds –0.98% in *residual PSI*, i.e., he or she underweights politically sensitive industries by about one percentage point relative to a typical fund with the same size and value characteristics. In contrast, a "strong" Republican holds 0.37% in *residual PSI* or slightly overweights politically sensitive industries. However, the Republican overweighting is not statistically or economically significant. The difference in politically sensitive holdings between strong Democrats and strong Republicans is –1.34%, with a *t*-statistic of 3.52. We also test whether there is a difference in the holdings of non-politically sensitive vice stocks such as alcohol and gaming and find no difference between Democratic and Republican donors.

Since SRI funds are more likely to be managed by Democrats, it is important to emphasize that we drop all SRI funds from these tests so differences in the holdings of managers from different parties are not picking up the mechanical underweighting of *PSI* by SRI funds. The typical SRI fund naturally underweights politically sensitive industries by 1.6 percentage points (adjusting for size and value characteristics), while a typical strong Democrat underweights *PSI* by about one percentage point. Thus, strong Democratic managers of non-SRI mutual funds are behaving nearly like SRI funds in their holdings of stocks in politically sensitive industries. Moreover, a manager's political affiliation is largely uncorrelated with other fund and manager characteristics. As such, our results are robust to controlling more finely for a host of other fund and manager characteristics in a multiple regression context.

We find similar results when we test whether managers of different party affiliations hold stocks with different KLD social ratings. The typical stock in a portfolio managed by a strong Democrat has a style-adjusted *KLD rating* of 14.64, whereas that of a strong Republican has a score of –2.54 (higher ratings represent better grades on social responsibility measures). The spread in scores between strong Democrats and strong Republicans is 17.18, with a *t*-statistic of 2.07. In contrast, a typical SRI fund has an adjusted score of 29, so the political ideology spread is again more than half of the spread between the holdings of SRI and non-SRI mutual funds, emphasizing the economic significance of our findings. These results are also robust to controlling for other manager and fund characteristics.

Beyond providing comfort in the robustness of our findings, the KLD measures are also useful in gauging whether Democratic managers not only avoid socially irresponsible stocks but also tilt toward stocks that are socially responsible. KLD ranks companies not only on the basis of "concerns" criteria (e.g., whether or not a firm does environmental damage) but also "strengths" criteria (e.g., whether a firm does a lot of charitable giving). As a result, we can see whether Democratic managers tilt toward firms that have more strengths. We find that more than a third of the higher ratings of stocks in Democratic managers' portfolios comes from seeking companies with strengths as opposed to avoiding companies with concerns.

We are not sure about the exact mechanism that explains how political values influence mutual fund managers' investment decisions. Our findings suggest that some form of "closet" SRI has been occurring in markets for some time, with potentially important implications for stock prices. Importantly, our findings are not about retail investors (who might or might not matter for price setting) but about mutual fund and hedge fund managers, who are presumably the arbitrageurs or marginal price setters in markets. The fact that Democratic managers are engaging in "closet" SRI and Republican managers are not doing much to counteract it implies a substantial effect of social responsibility on stock prices.

In reality, distinguishing between pecuniary and non-pecuniary reasons is a difficult task because the rationales are intimately connected and lead to very similar behavior. Nonetheless, we attempt to parse out the different motives. The work of Geczy, Levin, and Stambaugh (2003) suggests that if managers were simply indulging in non-pecuniary perks due to agency concerns, then their performance might suffer as a result. We find that the overall performance of Democratic and Republican managers does not differ significantly in spite of their different loadings on socially responsible stocks. At least on the surface, it does not appear that the behavior of Democratic managers is hurting them. However, the sample period is quite short, so we are cautious in drawing definitive inferences regarding performance.

We also look at the hedge fund industry for a better understanding of how agency issues affect managerial investment decisions. Because hedge fund managers often have a significant ownership stake in their funds and incentive-based fees are a large part of their compensation, we believe that they would be less likely to shift their investment holdings unless they thought it was in the best interest of their fund. Even though our data set of hedge funds is smaller, we find similar patterns in the fund holdings of Democratic and Republican hedge fund managers. These results are suggestive of the non-pecuniary theory.

We also test several alternative hypotheses that could explain our results. We show that our results are not a result of reverse causality (contributions responding to holdings), house effects (e.g., pressure by the upper management of the family), differences in clienteles, or social connections between managers and CEOs of the same partisan affiliation.

Our paper proceeds as follows. We describe the data in Section 2 and present the main results and additional analysis in Section 3. The implications of these results, particularly in light of the fast-growing SRI movement, are discussed in Section 4. We conclude in Section 5 with thoughts about future research. The supplementary Appendix (available online) provides details of the data-collection process for the political affiliation of managers, gives further evidence (largely based on state variation in taxes and regulations) for the classification of politically sensitive industries, and reports additional robustness checks.

Section snippets

Data

We begin with Morningstar Principia disks from 1992 through 2006 and focus on mutual funds run by a single manager, which constitute more than half of the mutual fund universe. (For team-managed funds, it is not clear how to categorize a fund managed by both Democrats and Republicans. Moreover, in some cases, fund management is simply reported as "Team Managed.") We have approximately 2,100 managers in our sample. The Morningstar disks provide names and tenures for each manager, along with…

Political values and holdings—funds sorted by political contributions

We first examine mutual fund holdings in politically sensitive industries. The results are presented in Panel A of Table 3. The dependent variable of interest is the residual holdings of stocks in politically sensitive industries. Industry loadings are adjusted for style effects by running cross-sectional (quarterly) regressions on *mean component log size* and *mean component log B/M* and assigning each observation the residual from these regressions. For example, the *residual* holding in tobacco…

Implications of our findings

One of the main critiques of the SRI industry is that it doesn't manage enough funds to affect stock prices and thus change firm behavior. However, this critique ignores the much larger pool of investment capital controlled by Democratic investors (whose underweighting of *PSI* or tilting toward high-KLD stocks is about 50% of that of SRI funds). Survey data show that Democrats and Democratic-leaning independents make up approximately 50% of the U.S. adult population.[9]…

Conclusion

In this paper, we ask whether political values influence investment decisions. We use data on the political contributions and stockholdings of U.S. mutual fund managers and find a surprising answer: managers who donate to Democrats underweight (relative to non-donors or Republican donors) stocks that are deemed socially irresponsible (e.g., tobacco, guns and defense, natural resources, and firms with low KLD scores). This effect is approximately one-half of the underweighting observed for...

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