Journal of Financial Economics 121 (2016) 521–545

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/finec

Capitalizing on Capitol Hill: Informed trading by hedge fund managers☆

Meng Gao, Jiekun Huang*

College of Business, University of Illinois at Urbana-Champaign, Champaign, IL 61820, USA

ARTICLE INFO

Article history:
Received 5 June 2015
Revised 6 October 2015
Accepted 4 November 2015
Available online 20 May 2016

JEL classification:
G11
G23
G14

Keywords:
Hedge funds
Lobbyists
Informed trading
Performance
Information transfer

ABSTRACT

This paper examines the hypothesis that hedge fund managers gain an informational advantage in securities trading through their connections with lobbyists. Using data sets on the long-equity holdings and lobbyist connections of hedge funds from 1999 through 2012, we show that hedge funds outperform passive benchmarks by 56–93 basis points per month on their political holdings when they are connected to lobbyists. Furthermore, the political outperformance of connected funds decreased significantly after the Stop Trading on Congressional Knowledge (STOCK) Act became effective. Our study provides evidence on the transmission of political information in financial markets and on the value of such information to financial market participants.

1. Introduction

Governments play an increasingly prominent role in influencing firms and stock prices. According to a Duke University/*CFO Magazine* Business Outlook Survey in 2013, federal government policies rank second only to consumer demand among the top three external concerns corporations face. The profound effects of political decisions on corporate performance and stock prices are evidenced by recent government policies and actions such as the bailouts of AIG and Bear Stearns, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Affordable Care Act. As a result, information regarding political decisions is of considerable interest to financial market participants. Yet, little is known about the dissemination and incorporation of political information or its value to financial market participants. In this paper, we

☆ We are especially grateful to Kathleen Weiss Hanley (the referee) for exceptionally thorough readings and constructive suggestions. We thank Vikas Agarwal, Heitor Almeida, Craig Brown, Alex Chinco, Tarun Chordia, Stephen Dimmock, Roger Edelen, Mara Faccio, Vyacheslav Fos, Andrea Frazzini, Fangjian Fu, Charles Hadlock, Campbell Harvey, Andrew Karolyi, Christopher Malloy, Pedro Matos, Neil Pearson, Joshua Pollet, Jeffrey Pontiff, Clemens Sialm, Melvyn Teo, Sheridan Titman, Mitch Warachka, Scott Weisbenner, Hao Zhang, as well as conference and seminar participants at the 2010 Financial Research Association annual meeting, the 2011 SFS Finance Cavalcade, the 2012 American Finance Association annual meetings, the Fifth Singapore International Conference on Finance, Baruch College, Drexel University, Georgetown University, Georgia Institute of Technology, Michigan State University, National University of Singapore, Purdue University, Singapore Management University, University of Illinois at Urbana-Champaign, University of Massachusetts Amherst, University of Miami, University of Oregon, University of Texas at Dallas, University of Washington, and Virginia Tech for comments and helpful discussions. We also benefit from conversations with Michael Mayhew at Integrity Research Associates and the team at VogelHood Research who provided valuable insights about the political intelligence industry. We thank Yih-Ling Ang, Zhe Du, Ruidi Huang, Jing Xie, and Si'en Yu for excellent research assistance. We retain responsibility for any remaining errors.

* Corresponding author. Tel.: +1 2173007024; fax: +1 2172443102.

E-mail addresses: menggao4@illinois.edu (M. Gao), huangjk@illinois.edu (J. Huang).

http://dx.doi.org/10.1016/j.jfineco.2015.11.001
S0304-405X(16)30080-0/

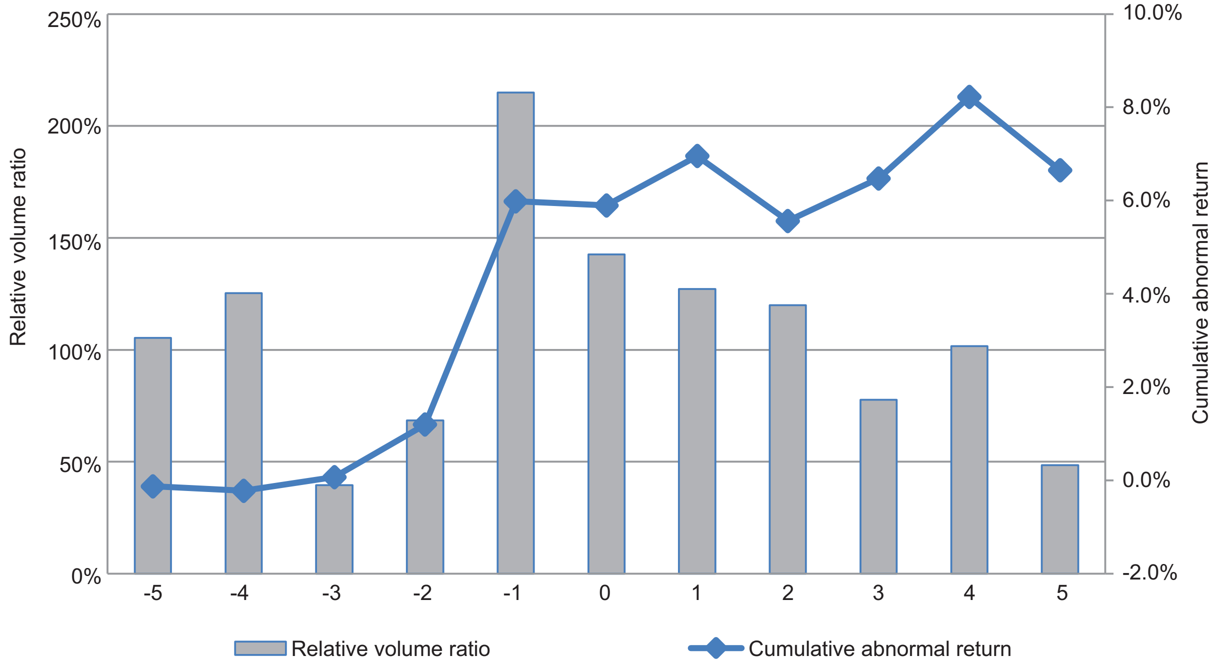

Fig. 1. Abnormal trading volume and returns of USG Corp. surrounding the public announcement of legislative news in November 2005. This figure plots the trading activity and abnormal returns of USG Corp. surrounding the public announcement of a bailout bill for companies facing asbestos litigation by the Senate Majority Leader on November 16, 2005 (Day 0). We track the abnormal trading volume and stock returns from the five days before through five days after the public announcement. The bars (left axis) plot the ratio of daily dollar volume during the event window to the median dollar volume in the one-year period before the event. The marked line (right axis) plots the cumulative market-adjusted return of the stock during the event window.

test the hypothesis that hedge fund managers obtain and trade on political information through their connections with lobbyists.

Lobbyists have access to political information because they routinely exchange information with legislators and many are themselves former legislators. A Wall Street Journal (2006) article reports that hedge funds find Washington to be a "gold mine of market-moving information." By hiring lobbyists, hedge fund managers can gain access to information about ongoing or impending government actions. As an example, consider the case of USG Corp., a building-material company facing an estimated $5.5 billion in lawsuits for asbestos-related injuries according to its 2004 annual report. On November 15, 2005, the company's stock was traded at 200% of its normal trading volume and delivered an abnormal return of almost 5% (see Fig. 1), yet no company-specific news was released on that day. On the following day, the Senate Majority Leader announced a plan to create a $140 billion bailout fund to relieve companies such as USG Corp. of their asbestos liabilities. It appears that the market reacted *before* the public announcement, which led the financial press to speculate that some investors traded ahead of the news, guided by consultants on "political intelligence" (Business Week, 2005).

The practice of lobbyists passing on material nonpublic political information obtained from within Congress to hedge funds has raised concerns among regulators, because it can compromise the integrity of the political process. The fact that members and employees of Congress were able to use confidential information acquired as a result of holding public office for personal gain could undermine the public trust placed in them; more disturbing is the possibility that it may lead to legislative decisions that would maximize private gain to lawmakers rather than serve the public interest (e.g., by increasing the demand for and the value of the information that lawmakers possess). Before 2012, trading by hedge funds on private political information obtained from within Congress did not violate insider trading laws because, first, neither the tippers (members of Congress and their staffers) nor the tippees (hedge funds) owed fiduciary duties to the issuers of the securities in which the hedge funds trade, and second, it was commonly believed that the tippers did not owe a duty of trust and confidence to the source of information (e.g., Jerke, 2010). The Stop Trading on Congressional Knowledge (STOCK) Act, signed into law in April 2012, imposes a duty of trust and confidence on government officials, thus exposing hedge funds that trade on private political information to potential insider trading liability. Nevertheless, the opaque nature of the political intelligence industry and enforcement challenges associated with the law have sparked an ongoing debate about whether it is necessary to institute a new law to specifically govern the transfer of political information in financial markets.

Our research provides evidence on how hedge funds benefit from access to political information. We make use of a large data set on long-equity holdings of hedge funds from 1999 through 2012 as well as a database of federal lobbying expenditures in the U.S. to identify potential information transfers from lobbyists to hedge funds. If hedge funds gain an informational advantage through their