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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.



## 1. 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, Kubik, and Stein, 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,

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[1] See the supplementary Appendix posted on the authors' websites for a discussion of partisan differences.

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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.

[2] See the Social Investment Forum's 2009 Report on Socially Responsible Investing Trends at www.socialinvest.org for statistics on the growth of SRI.

[3] However, if sociopolitical variables enter agents' utility functions, managers might also use their fund holdings to hedge against other non-stock-related adverse social or political outcomes. For example, Democratic managers might hold *more* tobacco or defense stocks prior to a close election to hedge against a perceived negative outcome in the election (a Democrat defeat). Thus, the prediction of the non-pecuniary hypothesis is not so clear-cut.