

LOBBYING EXPENDITURES AND SIN STOCKS' MARKET PERFORMANCE

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March 2018

Preliminary draft, please do not cite without authors' permission

Abstract:

Controversial firms, commonly known as sin stocks, are companies whose production and/or operations harm the society and/or the environment. Examples include organizations that are involved in the production of tobacco, alcohol, gambling, adult entertainment, as well as goods that are a part of developing ethical environmental and social issues such as, weapons, oil, nuclear, and biotechnologies (Hong and Kacperczyk, 2009; Cai, Jo & Pan, 2011; Kim and Venkatachalam, 2011). There are various factors that can cause a firm's stock price and overall value to fluctuate, including customer demand and societal pressures (Jo and Na, 2012). Companies involved in the above mentioned industries, are facing pressure from society as a result of manufacturing products

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that are hurting the environment and/or society as a whole. Recent researches suggest that corporate social responsibility (CSR) activists are becoming more successful in putting pressure on corporations, as they believe it is the responsibility of the company to answer to society's demands. Prior studies also argue that firms that engage in corporate social responsibility can reduce the likelihood of financial, social or environmental crises that could adversely influence their cash flows, along with generating "moral capital or goodwill"² which could protect their financial performance.

Despite the negative public perception of sin stocks, there is evidence that these firms generate significantly higher market returns (Lemieux, 2003; Morrissey, 2007; Fabozzi, Ma & Oliphant, 2008; Rosenberg, 2015). An article in *The New York Times*, reports that the Vice Fund – a fund that invests in sin stocks – increases their returns from the previous year by 14.1% compared to the 5.1% for the Standard & Poor 500 index, and outperforms the index each year since its inception (Morrissey, 2007). Fabozzi et al., (2008) find evidence that both U.S. and non-U.S. sin stocks earn a higher risk-adjusted return than the market, and in a more recent article, Rosenberg (2015) further confirms the outperformance of sin stocks against the S&P 500. The question of what drives the superior performance of sin stocks is a question that remains unanswered.

Stemming from this societal pressure, it is expected that firms in the controversial industries would face higher risk. In turn, it is argued that sin stocks will try and adopt strategies in order to improve public perception and their financial performance. This paper proposes to test whether corporate lobbying activities is among the strategies used by these firms to achieve higher market performance.

² Jo et al., (2012), page 2.

We examine the relationship between lobbying spending and the market performance of firms within the sin stocks universe. Considering the benefits of lobbying spending (through receiving bailouts during economic crises, preferential tax rates, government contracts, and tariffs), we conjecture that lobbying firms within the sin stocks universe will have higher returns than non-lobbying sin stocks. Using a sample of 286 firm-year observations for the period 2012-2015, we find that lobbying sin stocks have higher average returns than non-lobbying sin stocks. Moreover, it seems that the higher the lobbying spending, the higher the sin-stock market's performance. We also find that these lobbying firms enjoy a higher return when compared to a benchmark of non-sin stocks. However, we found no support to our hypothesis when we proxy for the market performance by the risk adjusted excess returns calculated using the Fama and French 3 Factor Model.

Key words: sin stocks, controversial industries, lobbying.