

Internet Appendix

Capitalizing on Capitol Hill: Informed Trading by Hedge Fund Managers

In this appendix, we provide additional tests of our main results. Section IA.I conducts various robustness checks. Section IA.II examines lobbying intensity around the STOCK Act. Section IA.III tests a direct implication of the influence hypothesis.

IA.I Robustness tests

IA.I.A Alternative measures of political sensitiveness of stocks

We construct two alternative measures of politically sensitive stocks. First, we use congressional sensitivity as an alternative measure of politically sensitive stocks. We calculate congressional sensitivity for each stock-year as the ratio of idiosyncratic volatility on days when Congress is in session to idiosyncratic volatility on days when Congress is in recess. If a stock becomes more volatile when Congress is in session than in recess, it is reasonable to believe that the stock is more sensitive to government policies and actions. We then calculate the equal-weighted congressional sensitivity for each four-digit SIC industry in each year. We sort the industry-level congressional sensitivity into deciles each year based on congressional sensitivity and define a stock-year as politically sensitive if the industry of the stock is in the top decile in the previous year. Second, we use the ratio of lobbying expenses to sales to identify political stocks. Specifically, we classify a stock-year as politically sensitive if the ratio of lobbying expenses to sales of the firm is in the top quintile of firms that incur lobbying expenses in the previous year. The results, reported in the first two panels of Table IA-1, show that the four-factor alpha of the DiD portfolio is around 45-82 basis points per month and significant at the 5% level, suggesting that our results are robust to these alternative measures of political stocks. The fact that the congressional sensitivity measure produces consistent results is noteworthy, because it indicates that the information generated is likely due to interactions with Congress and not the executive branch of the federal government.

IA.I.B Alternative weighting scheme

To construct calendar-time portfolios, we follow Cohen, Frazzini, and Malloy (2008) by first weighting returns by positions with funds and then by the total dollar holdings of individual funds. As a robustness check, we simply use dollar holdings value as weights to construct calendar-time portfolios. The results, reported in Panel C of Table IA-1, show that the four-factor alpha of the DiD portfolio is 85 basis points per month and significant at the 5% level.

IA.I.C Alternative risk benchmarks

We consider various alternative risk benchmarks to adjust the returns of the portfolios. First, to address the concern that the results may be driven by industry effects, we compute industry-adjusted stock returns by subtracting from each stock return over a period the return of the corresponding industry over the same period (following Moskowitz and Grinblatt 1999) and repeat the test using the industry-adjusted returns. Second, we repeat the tests using the Fama-French three-factor model as well as a liquidity-augmented Fama-French-Carhart model to adjust returns. We construct the liquidity factor IML (Illiquid Minus Liquid) using an algorithm similar to the one in Fama and French (1993) for their SMB and HML factors. Last, we use the modified four- and seven-factor models proposed by Cremers, Petajisto, and Zitzewitz (2013) to address the concern that the benchmarks have non-zero alphas. In all these robustness tests, we find qualitatively similar results as those reported in the paper. We report the results of these tests in Panel D of Table IA-1.

IA.I.D Alternative propensity-score matching

For robustness, we construct two alternative propensity-score matched samples for the calendar-time portfolio tests. The first uses the same matching criteria as in the holdings and trading tests, i.e., matching on fund size and portfolio concentration. The second matches on portfolio size, portfolio concentration, and the portfolio weight of political stocks. The results, reported in Panel E of Table IA-1, show that the four-factor alpha of the DiD portfolio continue to be significant and the magnitude is similar to that obtained using our original specification (in Panel B of Table 5).

IA.I.E Campaign contributions as an alternative channel

Hedge fund may be able to gain access to private political information through campaign contributions. In other words, politicians trade private political information for campaign contributions. To evaluate this possibility, we use campaign contributions to identify connected funds. Since political contributions may be a way to express political views (Hong and Kostovetsky 2012) or to gain access to politicians, we hypothesize that funds that contribute more heavily are more likely to gain access to politicians and hence trade on political information. We thus sort contributing funds into quintiles based on annual dollar contributions normalized by fund size. We classify a fund-year as connected if the fund is in the top quintile in the previous year and repeat the tests using this alternative proxy. Panel F of Table IA-1 shows that the four-factor alpha of the DiD portfolio is 29 basis points per month with a t -statistic of 1.60. The relatively small magnitude of political outperformance obtained here, as compared to that obtained using lobbying connections, suggests that a direct information flow from politicians to hedge funds seems less prevalent than information transfer through lobbyists. This is consistent

with the view that, because of public scrutiny and career or reputation concerns, lawmakers do not want to create the perception of quid pro quo relationships with campaign contributors (e.g., Fellowes and Wolf 2004; Issacharof 2010). When politicians directly communicate private political information to hedge fund donors, knowing that the latter are likely to use it to inform trading decisions, this is a clear indication of quid pro quo exchanges. In contrast, an important part of a legislator’s job is to exchange information with lobbyists, which enables lobbyists to act as conduits of information. We thus focus on lobbyist connections in the paper.

[Insert Table IA-1 about here]

IA.II Lobbying intensity around the STOCK Act

It is possible that the STOCK Act inhibited lobbying activities and reduced lobbyists’ ability to produce information due to reduced access to politicians, which may explain the decrease in connected funds’ political performance after the STOCK Act. To test this possibility, we track lobbying expenditures from four quarters before the enactment of the Act to four quarters after. Figure IA-1 shows that the aggregate amount of lobbying expenditures does not exhibit a discrete change around the enactment of the Act. This suggests that the Act does not curtail lobbying activities in general. We also track the lobbying revenues of lobbying firms that have hedge funds as clients during the same period. It is useful to note that the disclosed lobbying revenues of these hedge fund-connected lobbying firms are derived from lobbying on behalf of hedge funds as well as that on behalf of other interest groups. The idea here is that if these lobbying firms cut down their lobbying intensity after the enactment of the Act, they may have a reduced ability to produce political information, which may explain the drop in connected funds’ political outperformance post-STOCK. We find that these hedge fund-connected lobbying firms continue to generate similar levels of lobbying revenues, suggesting that they do not reduce their lobbying after the Act. Thus, insofar as lobbying revenues capture lobbyists’ access to and interactions with politicians, the decline in connected funds’ political outperformance after the STOCK Act does not seem to be driven by lobbyists’ reduced access to politicians. This is consistent with the guidance issued by the Senate, which states that “[the STOCK Act] is not intended [...] to chill legitimate communications made in good faith between public officials and their constituents, inhibit government transparency, or otherwise hinder the dissemination of public information about government activities.”

Moreover, we track the lobbying spending by hedge funds during the same period. The same figure shows that hedge funds reduce their lobbying expenses after the Act becomes effective. This may at first appear surprising considering that the STOCK Act was not intended to curb lobbying. However, our conversations with practitioners suggest that, even though it is not required by the law, some lobbyists disclose their political intelligence activities on the lobbying disclosure form, especially when the clients seek to interact with politicians and their staffers (which could be considered as borderline cases of lobbying under the Lobbying Disclosure Act

of 1995). Since the STOCK Act makes hedge funds liable for trading on confidential political information, the observed decrease in lobbying expenses incurred by hedge funds can be partly explained by reduced incentives to collect confidential political information.

[Insert Figure IA-1 about here]

IA.III A test of the influence hypothesis

The influence hypothesis predicts that connected funds should outperform more significantly on political holdings that are affected by the lobbying issues of the funds than on those that are not affected. For instance, a hedge fund may hire a lobbyist to lobby for healthcare legislation, which, according to the influence hypothesis, predicts that the fund should outperform more significantly on political holdings that are affected by this legislation. We assign politically sensitive stocks in each connected fund's portfolio to one of two portfolios: affected political stocks, those who lobby on the same issues as the connected fund; and unaffected political stocks, those that lobby on different issues. Table IA-2 reports the abnormal returns for the two portfolios. Connected hedge funds deliver statistically insignificant abnormal returns in affected political stocks, whereas their performance in unaffected political stocks is 57 to 88 basis points per month and highly significant. The differences in the alphas between the two portfolios are insignificant. This evidence suggests that hedge funds' political influence is not the main driver of our findings.

[Insert Table IA-2 about here]

Figure IA-1: Lobbying expenditures around the enactment of the STOCK Act

This figure plots lobbying intensities during the four quarters before and four quarters after the enactment of the STOCK Act. Quarter 0 is the second quarter of 2012 when the Act becomes effective. The solid line plots the aggregate lobbying expenditure by all businesses and organizations. The dashed line plots the lobbying revenue of lobbying firms that have hedge funds as clients. The dotted line plots the lobbying expenditure by our sample of hedge funds. The dollar value of lobbying expenditure/revenue is normalized so that the value in the second quarter of 2011 equals one.

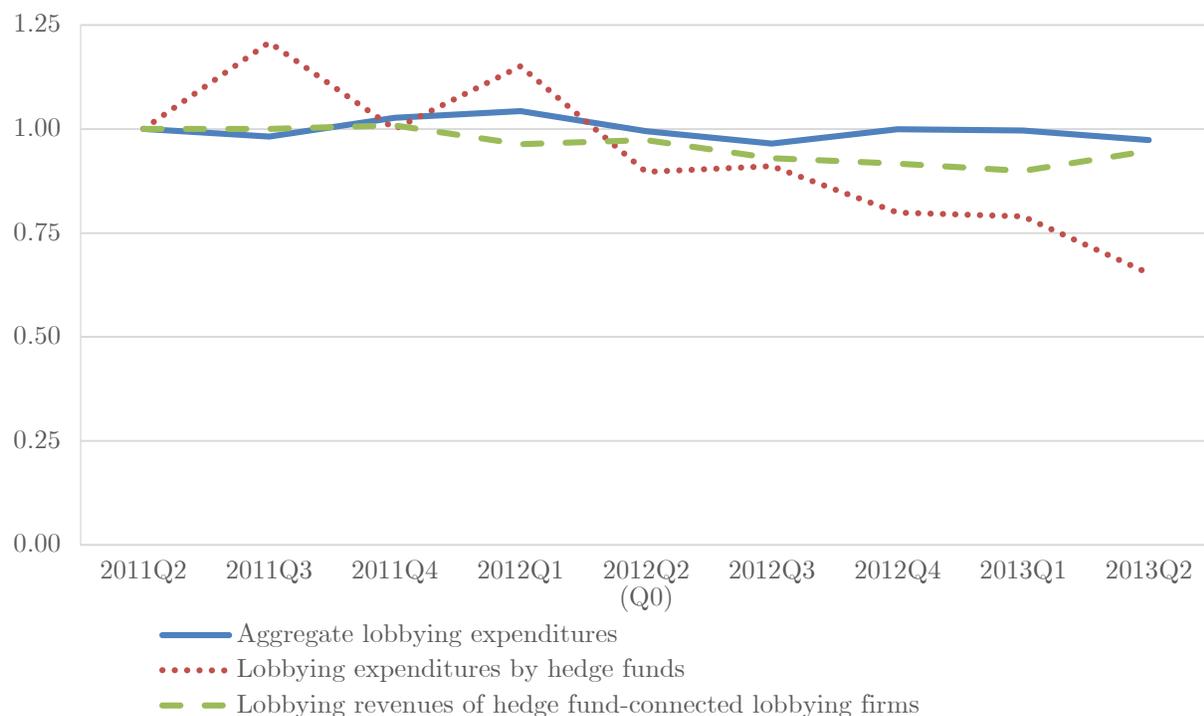


Table IA-1: Calendar-time portfolio returns: Additional tests

This table reports the four-factor alphas of the DiD portfolio. Panel A uses congressional sensitivity (at the industry level) to identify politically sensitive stocks. Panel B sorts firms that incur lobbying expenses into quartiles according to the ratio of lobbying expenses to sales and defines those in the top quartile as politically sensitive stocks. Panel C uses dollar holdings value as weights to construct the calendar-time portfolios. Panel D uses alternative risk benchmarks to adjust returns, including industry-adjusted stock returns (following Moskowitz and Grinblatt 1999), the Fama-French three-factor model, a liquidity-augmented Fama-French-Carhart model, and the modified four- and seven-factor models proposed by Cremers, Petajisto, and Zitzewitz (2013). Panel E uses alternative matching criteria for propensity-score matching. Panel F uses campaign contributions to identify connected funds. Numbers in parentheses are t -statistics. Significance at the 10% (*), 5% (**), or 1% level (***) is indicated.

	Diff-in-diff estimate of abnormal returns
<i>Four-factor DiD baseline estimate from Table 5, Panel A</i>	<i>0.89% (2.53)**</i>
A. Using congressional sensitivity to identify political stocks	0.45% (2.15)**
B. Using lobbying expenses-to-sales ratio to identify political stocks	0.82% (2.08)**
C. Alternative weighting scheme	0.85% (2.22)**
D. Alternative risk adjustments	
Using industry-adjusted abnormal returns	0.71% (2.09)**
Using the Fama-French three-factor model	0.86% (2.44)**
Using a liquidity-augmented Fama-French-Carhart model	0.78% (2.09)**
Using the modified four-factor model	0.82% (2.27)**
Using the modified seven-factor model	0.95% (2.55)**
E. Alternative propensity-score matching	
Matching on fund size and portfolio concentration	1.10% (2.87)***
Matching on fund size, portfolio concentration, and political holdings	1.04% (2.37)**
F. Using campaign contributions to identify connected funds	0.29% (1.60)

Table IA-2: A test of the influence hypothesis: Do connected funds use their political influence to trade profitably?

This table reports the abnormal returns of politically sensitive stocks held by connected fund managers partitioned by whether the stock is affected by the lobbying issues pursued by the hedge funds. Affected political holdings by a connected fund are politically sensitive stocks in the fund's portfolio that lobby for the same issues as the fund under consideration, and unaffected political holdings are otherwise. We track the monthly performance of all portfolios over the following three months and rebalance thereafter. For each portfolio, we report the four-factor alphas and the DGTW characteristics-adjusted returns. The last two rows report the difference in performance between each pair of portfolios. Numbers in parentheses are *t*-statistics. Significance at the 10% (*), 5% (**), or 1% level (***) is indicated.

	Four-factor alpha	DGTW-adjusted
Affected (firms and hedge funds lobbying on the same issues)	0.66% (0.98)	0.07% (0.12)
Unaffected (firms and hedge funds lobbying on different issues)	0.88% (2.59)**	0.57% (2.29)**
Outperformance (Affected – Unaffected)	-0.22% (0.33)	-0.50% (0.75)