Stock Market Consequences of Political Vibrancy

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Abstract.

We test the hypothesis that value-relevant information diffuses faster (slower) into stock prices of firms located in areas with (without) geographic ties to powerful politicians. Using two alternative measures of such ties as proxies for a location's political vibrancy, we show that there is more value-relevant information generated in politically vibrant areas, and that equity markets in these areas tend to be somewhat segmented from the rest of the country. Accordingly, stock returns of firms from politically vibrant areas predict those in non-vibrant areas. Consistent with the notion that an area's political vibrancy can affect local investor ability to process complicated information in a timely manner, this return predictability pattern is more pronounced among large firms and during periods characterized by higher uncertainty traced to random events constituting exogenous political shocks.

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I. Introduction

The U.S. political system of representative democracy is intended to provide a fairly even population-adjusted representation of the country's different locations in political bodies, such as state legislatures, Congress, and the President's administration. Nevertheless, there are naturally-occurring geographic clusters of higher levels of political activity and representation, where local communities' ties to politicians are much stronger than elsewhere.[1] We conjecture that areas with stronger geographic ties to powerful political actors are innately more "politically vibrant", in the sense that politics is more likely to provide a dominant common backdrop for locals' interactions with each other and to the way they conduct business.[2] Consequently, there should be greater production of value-relevant political information in these communities, and local investors should be more likely to participate in political elections, have more and better access to political information and use this information as a filter when absorbing market-related news. Whether an area's political vibrancy propelled by geographic ties to powerful politicians can cause local investors' information set to deviate from the norm and thereby affect stock market outcomes has not yet been investigated in the literature. We aim to fill this void through an empirical examination of US publicly listed stocks' over the 1967-2014 period.

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[1] Politicians develop ties to their "home base", which comprises their constituency areas as well as areas where they live or work. Wherever there are clusters of such ties, local communities become more politically vibrant; people with ties to local networks of political actors and their associates comprise an extended network of political information exchange that typically would not exist outside these politically vibrant clusters. Some of these clusters are static, such as state capital cities where there is a large concentration of political actors. Others are dynamic and occur through shifts in the political map, as is the case with states that are over-represented in a President's cabinet or administration and where it is more likely to find a relatively large number of individuals that are directly associated with administration members either as their employees, associates, friends, and/or family.

[2] Spatial proximity between politicians, their associates, and local citizens makes it more likely that commonly beneficial initiatives in government policy can be identified and advanced through the formation of political organizations and/or through informal political connections. Gimpel, Lee and Kaminski (2006) argue that spatial proximity lowers the barriers to organization by improving lines of communication and the formation of social ties. Busch and Reinhardt (2000) show that geographically concentrated firms are more likely to organize. In addition, Busch and Reinhardt (1999) and McGillivray (1997) provide evidence that such firms are more likely to gain protectionist concessions from government with respect to trade policy.

We hypothesize that geographic ties between firms' headquarter locations and powerful politicians can serve as pathways of value-relevant information flow into stock prices and, consequently, as the basis for return predictability strategies. Essentially, we argue that information related to value-relevant political developments that affect markets, the most common of which are new policy initiatives and related legislative activity, can be assessed in a more straight-forward manner by investors in politically vibrant areas. Hence, this information will be first reflected in the prices of firms located in politically vibrant areas, an effect propelled by the propensity of local investors to show preference for nearby firms' stocks, i.e., local bias (Coval and Moskowitz, 1999). Investors outside areas characterized by political vibrancy lack the access to the network linking political actors and local citizens which is necessary to enable deciphering value-implications of political information shocks to their local stocks in a timely fashion. Therefore, we hypothesize that these investors' relatively limited ability to process market-related political information can cause stock prices of firms in non-politically vibrant areas to respond to political information shocks with delay relative to their peers from politically vibrant areas.

The literature contains plenty of examples of the responsiveness of politically connected firms to information shocks (e.g., Roberts, 1990; Fisman, 2001; Faccio and Parsley, 2009, among others). There is also recent evidence consistent with the notion that cash flow relevant information processing is more straight-forward when firms are politically active. For example, corporate political strategies have been shown to act as a hedging mechanism effectively reducing equity prices' exposure to policy risk (Kim et al., 2015) and the impact of policy risk on firms' cost of debt (Bradley et al., 2015). Based on the above, we argue that when faced with uncertainty emanating from political events that can affect local firms, investors in areas with few geographic ties to political actors will be unable to quickly update prices in response to new information. Instead, they will resort to using the information included in the price paths of otherwise similar firms from politically vibrant areas as their guide and update prices of firms located outside politically vibrant areas accordingly, but with a delay. This effect would lead to return predictability running from firms located in politically vibrant areas to firms located outside these areas.

There are two mechanisms that can facilitate faster diffusion of value-relevant information into stock prices of firms located in politically vibrant areas. First, communities with greater political vibrancy typically exhibit greater levels of sociability (Brown et al., 2008) and political activism (Bonaparte and Kumar, 2013). In communities with greater degree of sociability information travels from investor to investor faster due to a stronger "word-of-mouth" effect. Political activism implies that local investors follow both political and financial news more intensely, have lower information gathering costs, and therefore are also expected to exhibit greater stock market participation.[3] Thus, a geographic area's abundance of connections to politicians may increase the local population's interest in, as well as its exposure and sensitivity to, political news. Also, it is conceivable that since investors in communities with strong geographic ties to powerful politicians have better access to social networks linking the politicians with the local citizens and business community, they will be more likely to acquire and analyze value-relevant political information.

Second, since local investors' information sets in politically vibrant clusters includes a more sizeable common political information component than the corresponding information set of investors outside these areas, the market for pricing of local stocks can become segmented and more pronounced local bias (Coval and Moskowitz, 1999) effects can emerge.[4]

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[3] Bonaparte and Kumar (2013) conjecture that politically active people follow political news more actively, and are therefore more likely to be exposed to financial news. Thus, they hypothesize that politically active investors' have lower information gathering costs and higher propensity to participate in the market. Wilson (1973) distinguishes among material, purposive, and solidary motives for political participation. We argue that geography can have an impact on each of the aforementioned types of motive.

[4] The literature provides ample evidence of investor tendency to show strong preference for local stocks. Domestic market segmentation in line with the existence of local bias has been documented in many papers, such

Pairing the effects of geographic ties to politicians with those of local bias, leads us to hypothesize that value-relevant information originating from politically vibrant areas will diffuse into the stock prices of firms located in these areas first, and then with some delay into the prices of similar firms located elsewhere. This stage-wise diffusion of information into prices should then result in stock returns of firms in politically vibrant areas leading those of their peers that are located in areas lacking an abundance of geographic ties to powerful politicians.

The literature's consensus seems to be that benefits from ties to politicians on average exceed the costs associated with establishing and maintaining the connections. For example, Roberts (1990), Fisman (2001), and Faccio (2006) provide evidence of net gains from political ties by using a methodology that highlights the sensitivity of connections based on campaign contributions or personal and family ties to events such as the establishment or termination of a connection. More recently, Faccio and Parsley (2009) and Pantzalis and Park (2014) show that connections based on geographic ties are valuable, yet risky.[5] However, there is very little direct evidence in the literature on the importance of geographic ties for the transmission of value-relevant information into stock prices. Providing evidence on the role of political vibrancy for the diffusion of relevant information into stock prices, is the focus of our study and its main contribution to the literature.

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as Hong, Kubik, and Stein (2008), or Pirinsky and Wang (2006). The literature has offered various explanations for local bias, ranging from information asymmetry (e.g., Ivkovic and Weisbenner, 2005; Massa and Simonov, 2006), to familiarity (Huberman, 2001), and to social networking (Hong, Kubik, and Stein, 2005). Aabo, Pantzalis and Park (2014) argue that "local bias can arise when there are market imperfections that render local market conditions different from national market conditions leading to local stocks exhibiting a significant local pricing component."

[5] Faccio and Parsley (2009) focus on location which forms a powerful basis for political connections (Roberts, 1990; Siegel, 2007) and use sudden deaths by politicians to identify the effect of political connections on the value of firms located in the geographic area the politician is mostly associated with. Their evidence indicates that geographic ties account for a large portion of firm value. Pantzalis and Park (2014) show that firm headquarters' geographic proximity to political power centers (state capitals) is associated with higher abnormal returns and argue that this effect is rooted in investor perception that there is more political risk associated with social networks linking politicians and firms.

We utilize a large sample of publicly listed U.S. stocks over a period of 47 years spanning the 1967-2014 period. We develop two measures, one static and one dynamic, of politically vibrant areas as clusters of political information production. The static measure gauges the degree of political vibrancy of firms' headquarter locations by proximity to state capitals where there is a large concentration of political actors and continuous political activity. The dynamic measure of political vibrancy is defined at the state level, by accounting for the extent of representation in the President's cabinet by politicians from that particular state.

Our empirical investigation is conducted in three stages. First, we establish that politically vibrant communities are more exposed to political news, and that locals are more likely to participate in the market. Using measures of public figures' corruption, dependence on government spending and corporate litigation as indicators of the local community's exposure to value-relevant political news we show that such exposure is significantly stronger when the local community is more politically vibrant. In addition, we find that areas with stronger geographic ties to powerful politicians display greater sociability and a higher voter turnout ratio, both proxies for greater propensity to participate in the market (Bonaparte and Kumar, 2013). In sum, this initial body of evidence supports the notion that our geographic ties' measures capture political vibrancy.

Second, we show that local bias in institutional investors' equity holdings and local comovement become stronger with political vibrancy. This result lends support for the notion that the market for local stocks in areas that are politically vibrant seems to be at least partially segmented, a necessary condition for the existence of return predictability effects. [6]

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[6] Aabo, Pantzalis and Park (2016) argue that when political considerations become disproportionately important at the local level and thus instrumental in shaping investors' perceptions about the impact of new and future policies and other political developments on local business conditions, local equity markets can become geo-politically segmented. In the presence of these conditions, local bias may ensue. Local bias, i.e. investors'

Finally, in the third and main stage of our investigation we provide evidence that spatial variation in political vibrancy is associated with return predictability, in support of the notion that value-relevant information flows from stock prices of firms located in politically vibrant areas to those of otherwise similar firms located outside politically vibrant areas. This evidence is derived from a series of return predictability tests using time series and cross-sectional tests utilizing a methodology inspired by the work of Cohen and Lou (2010) who tested and confirmed that returns of diversified ("complicated") firms lag (i.e. can be predicted by) those of pseudo-conglomerates formed by combining single-industry firms into a portfolio that mimics the structure of a specific conglomerate.

In order to conduct a test similar to the one in Cohen and Lou (2010) we would need to accurately match each firm from a politically vibrant area with an otherwise similar firm located in a non-vibrant area. In light of the difficulty in properly identifying the perfect match (i.e., a "clone" from non-vibrant areas) for each firm from politically vibrant areas, we use portfolios as our test assets. Specifically, we begin this part of our analysis using 125 pairs of portfolios consisting of firms from politically vibrant and non-vibrant areas, respectively. The 125 pairs of portfolios are formed by sorting firms independently into size, book-to-market ratio, and momentum quintiles as in Daniel, Grinblatt, Titman, and Wermers (1997) (hereafter DGTW). Every month we rank the 125 DGTW portfolios of firms headquartered in politically vibrant areas into deciles based on their prior month's returns.

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preference for local equity in domestic markets (Coval and Moskowitz, 1999), can arise when there are market imperfections that render local market conditions different from national market conditions leading to local stocks exhibiting a significant local pricing component. The local bias literature has documented domestic equity market segmentation in different contexts (Hong, Kubik, and Stein, 2008; Pirinsky and Wang, 2006) and offered alternative explanations for local bias, such as those based on information asymmetry (Ivkovic and Weisbenner, 2005; Massa and Simonov, 2006), familiarity (Huberman, 2001), and social networking (Hong, Kubik, and Stein, 2005). Aabo, Pantzalis and Park (2016) extend the framework of Hong, Kubik, and Stein (2008) and find that the inverse relation between market-to-book ratios and the ratio of the aggregate book value of firms to the aggregate risk tolerance of investors in a state (*RATIO*) is only prevalent among firms located in areas where politics have substantial influence on local markets. Their evidence is consistent with the view that political interference is a necessary condition for local bias in the stock market.

Next, in each decile we report the current month's equal- and value-weighted returns of the matching (i.e. of same size-, B/M- and momentum rank) portfolios of firms headquartered outside politically vibrant areas ("clones"). In support of our hypothesis, the risk-adjusted returns of "clones"' portfolios follow the pattern of their politically vibrant peers' lagged performance. Indeed, the results are consistent for portfolios of firms formed based on both measures of political vibrancy, i.e. when geographic ties are measured by proximity to state capitals as well as by the degree of firms' home state representation in the president's cabinet. The current month performance of "clone" portfolios consisting of firms lacking strong geographic ties to powerful political actors increases monotonically as one moves from the bottom to the top decile ranks of past month's corresponding politically vibrant portfolio performance. The abnormal returns of zero-net investment portfolios that are long clones of best performing politically vibrant firms in month t-1 (top decile) and short the clones of the worse performing politically vibrant firms in month t-1 (bottom decile) are not just statistically significant, but sizeable in economic terms as well. For example, when we perform the tests using the DGTW 125 portfolio pairs as test assets, the arbitrage portfolio returns range between 0.66% and 1.00% per month, depending on how firm location's geographic ties (political vibrancy) is measured, the type of asset pricing model used to adjust for risk (one-, three-, four- or five- factor model), and whether returns are equal- or value-weighted. In order to ensure that our results are not sensitive to the choice of DGTW portfolios as test assets, we also repeat all tests using matching pairs of portfolios formed based on industry and policy risk as alternative test assets.[7] The results we obtain are not just in line with but significantly stronger in terms of magnitude and significance compared

[7] This test involves two pairs of 147 portfolios as test assets. The 147sub-samples are based on the Fama-French 49 industries and the terciles of a policy risk measure inspired by Kim, Pantzalis and Par (2012) and based on the degree of party affiliation alignment with the President's party among the state's leading politicians.

with the evidence from the DGTW portfolios. In addition, we find strong confirming evidence of return predictability from cross-sectional tests using Fama-MacBeth regressions (Fama and MacBeth, 1973) of future non-connected "clone" returns as a function of lagged clone as well as lagged politically vibrant portfolio returns and other controls.

We inject another useful angle to test the information flow from politically vibrant areas to non-vibrant areas using analysts' forecasts. Security analysts repackage all publicly available information and generate high quality information. In additional test, we show that vibrant area firms' forecast revisions in the previous month can predict non-vibrant area firms' revisions.

When we repeat our return predictability tests for subsamples of firm size, we find that politically vibrant area firms' returns can predict returns of their peers in non-vibrant areas more when their size is large. This evidence is in line with the view that it will be difficult for investors to deal with small size firms due to the relatively higher levels of information asymmetry and the lack of political connections. Thus, the diffusion of value-relevant information from politically vibrant and non-vibrant areas may not be feasible.

Moreover, we examine whether our predictability patterns become more pronounced after the occurrence of exogenous shocks to the US presidential political system. We identify a set of presidential assassination attempts and plots that occurred during our sample period and divide our sample into periods experiencing unusual political uncertainty and "normal" periods. When we repeat our tests for the two periods separately we uncover that the predictability patterns are significantly stronger in the sub-periods characterized by unusual political uncertainty. This evidence also confirms our conjecture that the diffusion of information from politically vibrant areas' firms to non-vibrant area firms should be more noticeable following the occurrence of external information shocks.

Overall, the results provide strong evidence in line with the view that the notion that geographic ties between firms' headquarter locations and powerful politicians can serve as pathways of value-relevant information flow into stock prices. In the absence of such ties that promote political vibrancy and information production, we observe a stage-wise value-relevant information diffusion into stock prices causing return predictability running from politically vibrant area firms to non-vibrant area firms.

II. Data and Measures

II.1. Data Sources and Sample Selection

Data on stock price, return, and outstanding shares is obtained from the Center for Research in Security Prices (*CRSP*). Our sample covers a period from 1967 to 2014. From *Compustat*, we obtain annual data on accounting variables and the locations of firms' headquarters. In this paper we use headquarter or home office address information to assign firms to geographic locations. We also use the detailed address information from *Compact Disclosure* to account for address changes because *Compustat* provides only the latest address information without showing historical changes of firm location. We then require a firm to have financial and accounting data on *CRSP* and *Compustat*.

We collect information on the composition of all Presidential cabinets and consult biographic information from *Wikipedia* to identify each cabinet member's home state. A home state is not necessarily the state of birth, but the state with which the politician is mostly identified with, in terms of his political career and/or business and residence. For example, President George H. W. Bush was born in Connecticut but was always known to be a politician from Texas.

Our two alternative variables used as proxies of policy risk are variables that measure political alignment with the President at the state level and in essence capture firms' proximity to political power. The rationale for using political alignment measures is that both policy risks and local politicians' influences increase with proximity to political power. Our first policy risk variable, coded *party alignment*, captures alignment based on partisanship. We follow Kim et al. (2012) using election results. General elections held every two years in the United States and thus new party alignment for each state emerges from each election. We collect detailed information on party affiliation and control from different volumes of "*Taylor's Encyclopedia of Government Officials: Federal and State*" and "*State Elective Officials and the Legislatures*." Our second policy risk variable, coded *ideology alignment*, captures political alignment in an ideological sense. It is measured by the distance between the political ideologies of local politicians and those of the President. Local politicians in this case are politicians representing the particular state as members of Congress' House and Senate chambers. Information on the Congress members' ideology scores is obtained from the site provided by Professor Keith Poole (http://voteview.com/index.asp).

II.2. Measures

II.2.A. Political Vibrancy Measures

We conduct our empirical examination of the impact of area political vibrancy on the diffusion of value-relevant information into stock prices by using two alternative measures based on geographic ties between important political actors and local population.

II.2.A.1. Cabinet Geographic Tie Indexes

The first approach to measuring an area's political vibrancy is by assessing the geographic ties between an area and members of the Presidential cabinet. We utilize three levels of the Presidential cabinet breadth, where broader (narrower) levels of the cabinet allow the inclusion of more (less) members with limited (considerable) degree of political power and influence on Presidential policies. The narrowest version of our cabinet definition, Level 1, includes only the President, the most powerful member of the administration. Level 2 includes the President, the vice-President, the "big four" cabinet members (i.e. Secretary of State, Secretary of Treasury, Secretary of Defense, and Attorney General) and the Chief of Staff. Finally, the broadest version of the cabinet, Level 3, includes the Level 2 members and eleven other cabinet members (Secretary of Interior, Secretary of Agriculture, secretary of Commerce, secretary of Labor, Secretary of Health, Education and Welfare, Secretary of Housing and Urban development, Secretary of Transportation, US Representative to the United Nations, Chair of the council of Economic Advisers, director of the Office of Management and Budget, and Head of the Office of Trade Representative).

Corresponding to the three aforementioned levels of the cabinet, we then create three geographic ties' measures, which we label *cabinet ties index* (*CTI*), for every two-year period following an election and for every state as the product of the number of the service years by cabinet members from that state and a weight reflecting the allocation of power at the particular level of the cabinet. Specifically, in *CTI1* all political power rests with the President, in *CTI2* 50% of the political power is allocated to the President and the remaining 50% equally divided among the six Level 2 cabinet members, and in *CTI3* one third of the political power rests with the President, one third is equally divided among Level 2 cabinet members and the remaining one third is equally divided among the eleven Level 3 cabinet members. Since our analysis is based on two-year intervals, we divide the products of the service-years and political power weight by two so that in its final form the three versions of the geographic tie index take values between zero and one.

Thus, the three alternative *CTI* measures are computed for each state *j* every year as follows:

$$CTI1_j = Level1_j, \tag{1a}$$

$$CTI2_j = \tfrac{1}{2}Level1_j + \tfrac{1}{2}Level2_j, \tag{1b}$$

$$CTI3_j = \tfrac{1}{3}Level1_j + \tfrac{1}{18}Level2_j + \tfrac{1}{33}Level3_j, \tag{1c}$$

where $Level1_j$ is an indicator of the home state of the President. $Level2_j$ ($Level3_j$) is the total number of level 2 (level 3) cabinet members from state *j*. If a member's background split into more than one state, we assign a value to each state after dividing by the number of states.

II.2.A.2. Proximity to Political Power Centers

We also rely on the premise that geographic proximity is the most basic source of homophily that leads to the creation of social networks to operationalize an area's political vibrancy. Thus, we consider proximity of a firm's headquarters to political power centers - state capitals where there is a large concentration of political activity. Actual distance in statutory miles is computed based on the formula for the distance $d(a, b)$ between two points, a and b, as follows:

$$d(a,b) = arcos\{cos(a_1)cos(a_2)cos(b_1)cos(b_2) + cos(a_1)sin(a_2)cos(b_1)sin(b_2) + sin(a_1)sin(b_1)\}r, \tag{2}$$

where a_1 and b_1 (a_2 and b_2) are the latitudes (longitudes) of the two points (expressed in radians), respectively. r denotes the radius of the Earth, which is approximately 3,963 statutory miles.

We then follow Pantzalis and Park (2014) to model the distance between firm headquarters and state capitals after controlling for other factors that prior studies (e.g., Ross, 1987; Holloway and Wheeler, 1991; Shilton and Stanley, 1999) have shown to affect corporate headquarters location. We then compute our second political vibrancy proxy, proximity (*PROX*), as the difference between expected and actual distance, i.e. by the negative value of the residual obtained from estimating the following regression model.[8]

$$Distance\ to\ capital_{i,y} = b_0 + \Sigma b\ State_{i,y} + \Sigma b\ Capital_{i,y} + \Sigma b\ Firm_{i,y} + \Sigma b\ Industry\ dummies + \varepsilon_{i,y}, \quad (3)$$

where *Distance to capital* is the number of statutory miles between the firm headquarters and the state capital city locations. *State* is a vector of state-specific variables, including *State size* (in square miles) and *State population*. *Capital* variables include the capital city's population as a percent of the total state population (*Capital's relative population*), its distance from other large population areas (*Distance of capital from the next large city*) and an indicator variable that takes a value of one if the capital city is a Metropolitan or Micropolitan Statistical Area (*MSA*) and a value of zero, otherwise. *Firm* variables include the *Percentage of same industry firms close to capital*, the *Number of large cities around the firm*, and *Firm age*. We also control for industry effects using 11 industry dummies, constructed based on the Fama-French 10-industry classification. For a more detailed description of the construction and estimation of the distance model shown in (3), please refer to Pantzalis and Park (2014).[9]

II.2.B. Political Alignment

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[8] A common observation from these earlier studies is that there is a high degree of clustering of corporate headquarters in large metropolitan areas. This agglomeration in and around large cities has been primarily driven by corporations' need to have their headquarters located near areas where there is an abundance of business services, like financial intermediaries (Henderson and Ono, 2008) and transportation (i.e., airports, major highways etc., see Brueckner, 2003; Bel and Fageda, 2008). Moreover corporate headquarters' agglomeration has been observed among firms belonging to the same industry, as firms seek to obtain new ideas and talent through interaction and proximity to similar firms (Porter, 2000; Walcott, 2001). The trend of headquarters flows toward metropolitan areas has continued over the years, however more recent studies have denoted a long-term trend of "deconcentration" of headquarters, wherein headquarters flow has gradually shifted toward metropolitan areas that do not rank among the largest in size (Klier and Testa, 2002; Diacon and Klier, 2003).

[9] As discussed in Pantzalis and Park (2014), the two main concerns with *PROX* is a)whether it correctly identifies the effect of proximity to political power, and b) whether it indeed captures the likelihood of social ties between firms and politicians. They proceed to address both issues and put both concerns to rest.

We use a measure of political alignment with the President's administration at the state level, inspired by Kim, Pantzalis and Park (2012) and constructed by accounting for the degree of Presidential party control of a particular state's political institutions (governor mansion and state legislatures) and for the percentage of the state's representatives in Congress (the state's representatives in Senate and House) that belong to the President's party. In its main form, this political alignment index, PAI_j, is constructed by giving equal weight to the portions of each of the state's delegations in the two chambers of Congress that are aligned with the President's party and to the President's party control of state politics.

$$PAI_j = \tfrac{1}{4} S_j + \tfrac{1}{4} R_j + \tfrac{1}{4} G_j + \tfrac{1}{4} [\tfrac{1}{2} S_j^{state} + \tfrac{1}{2} R_j^{state}], \quad (4)$$

where S_j = the fraction of the state's two senators in Washington that belong to the President's party. R_j = the percentage of the state's house representatives in Washington that belong to the President's party. G_j = a dummy variable equal to one if the governor belongs to the same party as the President, and zero otherwise. S_j^{state} = a dummy variable equal to one if the percent of members of the state senate belonging to the President's party is greater than 50%, and zero otherwise. R_j^{state} = a dummy variable equal to one if the percent of representatives in the state house belonging to the President's party is greater than 50%, and zero otherwise.

III. Findings

Our main sample spans the years 1968-2014. Descriptive statistics for the variables used in our multivariate tests are summarized in Table 1. As discussed in the first section of the paper, our empirical investigation is completed in three stages: First, we provide evidence on whether our political vibrancy measures vary with proxies for information production.

*** INSERT TABLE 1 ***

III.1. Are Politically Vibrant Areas Characterized by More Value-Relevant (Political) News and Greater Stock Market Participation?

We utilize three proxies for the level of political activity and production of value-relevant political information: the number of convictions of local (state) public officials, a state's dependence on government spending, and an indicator that a lawsuit has been filed against a particular firm in a given calendar year. *Convictions* has been used by prior studies as a measure of corruption (e.g., Butler, Fauver and Mortal, 2009; Kim et al., 2012) and is expected to be increase with the level of political activity. Similarly, we expect that states with more ties to the administration to display greater dependence on government spending (Pantzalis and Park, 2014). Since the *Convictions* and *Dependence on government spending* variables are measured at the state level, we can only test their relationship to the political vibrancy proxy that is measured at the state level, i.e. to the cabinet ties measure, *CTI*. Panel A of Table 2 shows mean values of *Convictions* and *Dependence on government spending* for states sorted on *CTI3*, the broadest of the three alternative *CTI*s.[10] As expected, both *Convictions* and *Dependence on government spending,* on average, increase monotonically with *CTI3*, consistent with the notion that political activity and political information production rises with an area's degree of geographic ties with the administration.

In Panel B of Table 2 we present mean levels of the likelihood of corporate litigation for groups of firms sorted on *CTI3* and *PROX*. In line with evidence from Panel A, the results show that there is a significantly higher probability of been involved in a lawsuit if the firm is located in a state with strong ties to the cabinet (*CTI3*) than if it were located in a state

[10] We only show results based on *CTI3* in this paper, but those obtained from the other two measures are qualitatively similar and available from the authors upon request.

with not ties to the President's cabinet (*CTI1*). Moreover, we show the same strong pattern and significant differences between extreme groups, when we compare firm locations based on proximity to state capitals (*PROX*). Overall, the evidence from Table 2 indicates that both of our proxies of political vibrancy are associated with measures that are indicative of strong political activity and politics-related information production at the local level.

*** INSERT TABLE 2 ***

In Table 3 we show results of two tests designed to provide evidence on whether our political vibrancy proxies are associated with greater propensity of locals to participate in the stock market. We use a measure of the local community's sociability (Brown et al, 2008) and voter turnout (Bonaparte and Kumar, 2013) as proxies for local residents' propensity to participate in the stock market. Panel A shows that the state-level average community politics/sociability increases monotonically with both *CTI3* and *PROX*, in line with the view that politically vibrant areas are characterized by significantly stronger levels of sociability than non-vibrant areas. In Panel B of Table 3 we estimate a multivariate model of voter turnout as a function of *CTI3* as well as many other control variables. We show that voter turnout (at either the state- or the county level) in the next election is significantly correlated with *CTI3*. Assuming that voter turnout ratio is a reliable proxy for stock market participation (Bonaparte and Kumar, 2013), our results lend strong support to the notion that political vibrancy is associated with greater propensity to participate in the stock market.

*** INSERT TABLE 3 ***

Taken together, the findings from Table 2 and 3 imply that our political vibrancy proxies indeed capture higher-than-normal levels of political news and value-relevant information production associated with a higher propensity to participate in the stock market.

III.2. Are Politically Vibrant Areas' Markets Segmented Along Geo-Political Lines?

To answer this question, we first examine politically vibrant area investors' preference for local equity (Coval and Moskowitz, 1999). We focus on institutional investors' shareholdings since prior research suggests they are more influential for asset pricing, given the fact that they are more sophisticated and have an information advantage relative to retail investors (Hand, 1990; Ke and Petroni, 2004; Collins, Gong, and Hribar, 2003; Amihud and Li, 2006; El-Gazzar, 1998; Bartov, Radhkrishnan and Krinsky, 2000; Balsam, Bartov, and Marquardt, 2002).

We collect information on institutional investors' shareholdings from Thomson Reuters. Thomson Reuters provides data on institutional ownership from as early as 1978, but we comprehensive coverage does not start until the first quarter of 1980. Thus, we test the effect of political vibrancy on institutional biased ownership of local equity for the period from 1980 to 2012.

We first calculate the ratio of the proportion of stock shares in the state owned by institutions headquartered in the state to the proportion of state's total equity value in the U.S. market. For each state in every year, we then compute *institutions' biased holdings of local equity (state-level)* by taking the log of one plus the state average of institutions' ratio values. We replicate these steps at the MSA level to compute an equivalent MSA-level measure.

In Panel A of Table 4, we compare the average values of the state-level *institutions' biased holdings of local equity* for the zero-, low- and high *CTI3* sub-groups. The average value of *institutions' biased holdings of local equity* is 1.0900 for the zero *CTI3* group and monotonically increases to 1.5030 for the high *CTI3* group. The difference (0.4130) is statistically significant at 1% level, indicating that local bias is more pronounced in politically vibrant areas than in non-vibrant areas. We also conduct a *PROX*-based comparison of the *institutions' biased holdings of local equity* measure at the MSA level. MSAs are included in either the capital MSA group, if they contain a state capital, or in the non-capital MSA group, if they do not contain a state capital. The average MSA-level *institutions' biased holdings of local equity* is higher for the capital MSAs, which indicates that local bias is more pronounced around state capitals where political vibrancy is stronger.

We conduct regression analysis in Panel B of Table 4. The first model is estimated at the state level and the dependent variable is the state average of *institutions' biased holdings of local equity*. The key independent variable is *high CTI3 state dummy*, an indicator variable that takes a value of 1 if the state is included in the top tercile of *CTI3*, and 0 otherwise. We also control for other state characteristics that could potentially affect local bias in a state, such as *state population density*, state population divided by state size in square mile, and *number of bordering states*. The second model is estimated at the MSA level and the dependent variable is the MSA average of *institutions' biased holdings of local equity*. The key independent variable here is *Capital MSA dummy*, which takes a value of 1 if the MSA contains the state capital and 0 otherwise. We also include two MSA-level control variables: *MSA population density* and *distance from the next large city*. The results confirm that local bias is more pronounced when the MSA contains the state capital, when proximity to political power and political vibrancy are at the highest level. Overall, the results of the multivariate tests reported in Panel B confirm the univariate results and together imply that equity markets in politically vibrant areas can become partially segmented.

*** INSERT TABLE 4 ***

In the next step of our analysis we test the hypothesis that political vibrancy should be associated with stronger local comovement. This hypothesis is based on the argument that when politics shapes local investors' perceptions about the impact of political and economic developments on local firms' performance in a way that is not shared by others outside the area, local equity markets can become geo-politically segmented.

Table 5 includes the local comovement test results. We follow the methodology of Kumar, Page and Spalt (2013) and estimate the following time series model:

$$r_w^i - r_w^f = a_0 + \beta_{market}\,(r_w^{market} - r_w^f) + \beta_{local}\,(r_w^{local} - r_w^f) + s\,SMB_w + h\,HML_w + u\,UMD_w + e_w, \qquad (5)$$

where r_w^i is an individual firm's weekly return; r_w^f is the one-week Treasury bill rate; r_w^{market} is the value-weighted market return; r_w^{local} is the equally-weighted return of all stocks from the firm's corresponding MSA; *SMB* (small minus big) is the difference each week between the return on small and big firms, while *HML* (high minus low) is the weekly difference of the returns on a portfolio of high book-to-market and low book-to-market firms and *UMD* (up minus down) is the momentum factor computed on a weekly basis as the return differential between a portfolio of winners and a portfolio of losers.

In Panel A of Table 5 we report the β_{market} coefficient from a model similar to (5) that does not include the local MSA market portfolio returns and, in the last two columns, the β_{market} and the β_{local} coefficients from the estimation of model (5). The coefficients of the local MSA market are increasing monotonically as one moves from low political vibrancy to high political vibrancy areas, regardless of the proxy used, i.e. *CTI3* or *PROX*. This finding is consistent with the notion that local comovement is, on average, higher in areas where there are stronger ties with powerful politicians. In Panel B of table 5 we report the results of a regression model of β_{local} as a function of *CTI3* (or *PROX*) and other controls following Kumar et al. (2013). Both *CTI3* and *PROX* are significantly positively correlated to β_{local} in support of the hypothesis that political vibrancy can contribute to the segmentation of local equity markets.

*** INSERT TABLE 5 ***

III.3. Can politically vibrant area firms' past performance predict non-politically vibrant area firms' future performance?

III.3.1. Time series tests evidence

In Table 6, we test the hypothesis that return predictability runs from politically vibrant areas' stocks to those located in areas that are not politically vibrant using the third-level cabinet ties' index (*CTI3*) and the degree of geographic proximity to state capitals (*PROX*) to classify firms as located in politically vibrant areas or not. We first sort politically vibrant and non-politically vibrant areas' firms into 125 pairs of portfolios based on the DGTW classifications. In Panel A, we classify each of the DGTW portfolios with zero *CTI3* values (i.e., consisting of firms with no cabinet ties) into the decile where its corresponding (DGTW- characteristic-matched) test asset with non-zero *CTI3* values has ranked based on previous month performance. We then show the current month's average excess returns and the estimated intercept coefficients (i.e., the "alphas" or abnormal returns) from time-series tests with asset pricing models containing 1, 3, and 4 factors, respectively, for each decile portfolio of DGTW test assets with zero *CTI3* values. In Panel B, we repeat the procedure using *PROX* instead of *CTI3*. Specifically, we classify each of the DGTW portfolios consisting of firms with low *PROX* values (i.e., firms located far away from state capitals) into the decile where its corresponding (DGTW- characteristic-matched) test asset consisting of high *PROX* values' firms has ranked based on previous month performance. We then, show the current month's excess returns and alphas for the all decile portfolios consisting of DGTW test assets with low *PROX* values. This procedure allows us to set non-politically vibrant portfolios' monthly returns at *t* and politically vibrant portfolios' monthly returns at *t*-1 in a panel setting. Since our test employs firms' monthly returns, portfolio rankings are rebalanced every month. To ensure that our results are not driven by known factor loadings, we construct a zero-cost investment strategy that buys the top decile and sells the bottom decile of non-politically vibrant area firms and compute its performance using various time-series asset pricing models. Dependent variables are the differences in monthly equally-weighted and value-weighted returns between the top ($R_m^{Topdecile}$) and the bottom ($R_m^{Bottomdecile}$) decile of non-politically vibrant area firms' current returns at a portfolio level. The asset pricing models used to assess the abnormal returns of the zero-cost investment strategy are as follows:

$$\text{1 Factor: } R_m^{Topdecile} - R_m^{Bottomdecile} = \alpha_0 + \beta_1 MKT_m + e_m, \quad (6a)$$

$$\text{3 Factor: } R_m^{Topdecile} - R_m^{Bottomdecile} = \alpha_0 + \beta_1 MKT_m + \beta_2 SMB_m + \beta_3 HML_m + e_m, \quad (6b)$$

$$\text{4 Factor: } R_m^{Topdecile} - R_m^{Bottomdecile} = \alpha_0 + \beta_1 MKT_m + \beta_2 SMB_m + \beta_3 HML_m + \beta_4 UMD_m + e_m. \quad (6c)$$

We find that the *non-politically vibrant areas' firms* average monthly returns are positively related to the *politically vibrant areas' firms* preceding returns, supporting our expectation that information processing is slow for firms whose local investors do not have access to a wealth of political information. In all four columns, returns show a monotonically increasing pattern as one moves from the lowest to the highest decile. At the bottom of each column, we also show the differences in the estimated intercept coefficients between the top and bottom deciles. Overall, our findings strongly support the notion that politically vibrant area firms' past performance has strong return predictability for their non-politically vibrant area peers' future performance. For example, when political vibrancy is proxied by *CTI3*, all alternative zero-net investment portfolio returns (i.e., the equally- or value-weighted returns from the different asset pricing models) yield positive abnormal returns ranging from a minimum of 0.66% to a maximum of 1.00% per month and statistically significant at least at the 1% level.

*** INSERT TABLE 6 ***

The return predictability tests shown in the previous table are utilizing the pairs of 125 DGTW characteristics-based portfolios as test assets. One could argue that these test assets would be more appropriate for testing whether there is of slow diffusion of market-wide information shocks from politically vibrant to non-vibrant area firms. However, one could argue that a more appropriate set of test assets should be based on industry classification while at the same time accounting for the degree of exposure to uncertainty about future policies that can be attributed to a firm's location in the political map. We therefore repeat our tests using test asset portfolios from industry and policy uncertainty combinations. We create 147 pairs (i.e., politically vibrant area firms and non-politically vibrant area firms) of test assets formed after independently sorting firms into 49 Fama-French (1997) industries and 3 political alignment index (*PAI*, a proxy for policy uncertainty as per Kim et al. (2012)) groups. In Table 7 we repeat the tests from the previous table using the industry- and party alignment-based pairs of test assets. The results we obtain are even stronger than those based on the DGTW pairs of test assets. For example, as shown in Panel A of Table 7, the zero net-investment portfolio alphas from the different asset pricing models range between 1.03% and 1.32% per month.

Overall, the evidence from the last two tables lends supports to the hypothesis that return predictability runs from politically vibrant to non-politically, and in line with the view that information diffuses slowly into prices.

*** INSERT TABLE 7 ***

III.3.2. Cross-sectional tests evidence

To test whether support for our hypothesis remains robust in a cross-sectional framework, we proceed by estimating Fama-MacBeth regressions, wherein the dependent variable is the return of the non-politically vibrant (zero *CTI3* or low *PROX*) area test asset (either DGTW or industry-PAI portfolio) in month t. The list of the independent variables includes the *Clone past return (-1, -1),* i.e. the previous month's return of the portfolio with non-zero *CTI3* (or higher *PROX*) values in the test asset same category; *Past return (-1, -1)*, i.e. the previous month return of portfolio with zero *CTI3* (or low *PROX*) values in the same test asset category; *Past return (-4, -2)*, i.e. the zero *CTI3* (or low *PROX*) portfolio's average monthly return over the three-month return from month -4 to month -2; *Size*, i.e. the zero *CTI3* (or low *PROX*) portfolio's average size; *B/M*, i.e. the zero *CTI3* (or low *PROX*) portfolio's average B/M; *Turnover,* i.e. the zero *CTI3* (or low *PROX*) portfolio's average monthly mean turnover in the previous year. The results of the cross-sectional analysis, shown in Table 8, are in line with those obtained from the time series asset pricing tests. The current month's return of non-politically vibrant area firms' portfolios are positively correlated with the previous month's returns of their "clones", i.e. their DGTW characteristics- or industry and PAI-matched portfolios consisting of firms from politically vibrant areas. Thus, the cross-sectional tests provide further support to the hypothesis that return predictability runs from firms with geographic ties to powerful politicians to those firms that are located in areas with few ties to powerful politicians.

*** INSERT TABLE 8 ***

III.3.3. Forecast revisions

We have shown that return predictability moves from politically vibrant to non-politically, supporting the argument that information diffuses slowly into prices. As one of major information intermediaries in the financial markets, security analysts generate high quality information after analyzing all publicly available information.

Therefore, we can conjecture that vibrant area firms' forecast revisions at m-1 can predict non-vibrant area firms' revisions at time m. To test this, we collect forecast information I/B/E/S and calculate revision from month to month using the median forecast value. In case that forecast is missing for particular months, we use the last available median forecast value. As done in the return analysis, we construct the 125 DGTW portfolios and the 149 industry-PAI portfolios in order to see whether the forecast revisions of vibrant area firms in the previous month can predict that of non-vibrant area firms.

We report the cross-sectional regression results in Table 9. Consistent with the results in the previous table, the forecast revision of the pair portfolio is positively and significantly related to the forecast revision of the corresponding clone portfolio in the following month. The significant positive relationship is robust to all classification and the way of weighting for portfolio average revisions.

*** INSERT TABLE 9 ***

IV. Further Evidence on Slow Information Diffusion

IV.1. Information asymmetry

We now turn our attention to alleviating concerns that our test results can be attributed to confounding effects and to solidify the argument that market-relevant information can diffuse into the stock prices of otherwise similar firms' at different speeds. Holding everything else constant, the severity of the information diffusion effect we have demonstrated should depend on investors' access to process value-relevant political information. For investors to understand the effect of political connections, it would be difficult when they handle small size firms due to the relatively higher levels of information asymmetry and the lack of political connections. Specifically, if the return predictability patterns we have documented thus far are rooted in market segmentation caused by differences between local and non-local investors' information sets, we should expect to see much weaker (stronger) patterns among small (large) firms.

Therefore, we repeat our tests separately for groups of firms with small-, medium- and large-size firms and report the zero net investment portfolio alphas from 1-, 3- and 4-factor models on equally-weighted and value-weighted monthly returns, and based on both the *CTI3* and the *PROX* proxies of political vibrancy. The results in Table 10 indicate that our previously reported patterns of predictability are most pronounced for the group of firms with large-size firms, while they get generally stronger with firm size. This evidence is in line with the view that the slow diffusion of market-relevant information from politically vibrant areas firms to otherwise similar firms located outside such areas may not be feasible for small-size firms because it is difficult for investors to expect the effect of political vibrancy for the similar small-size firms.

*** INSERT TABLE 10 ***

IV.2. Exogenous political shocks

An additional concern about our findings is that they could have been generated by simple autocorrelation in returns. Specifically, it could it be that returns of industry- and size matched firms in a particular month predict the returns of other firms in the same portfolio the next month. Since autocorrelation in returns would be consistent with the results we have shown but has nothing to do with the slow diffusion of political value-relevant information hypothesis, we need to better identify the source of the return predictability effects we documented earlier.

One way to clearly show that access to political vibrant information networks is at the core of the effects we have shown, is to demonstrate that they can be triggered by political events that can affect the degree of segmentation of investors' information environments along geo-political lines. Such events should be random and not endogenously determined by economic or political developments and their economic impact should be rooted in uncertainty that is easier to be deciphered by investors in politically vibrant areas than by investors outside those areas. We argue that a set of events that would closely fit the aforementioned requirement (i.e., to exogenously increase the level of uncertainty for investors but at different degrees depending on their location's political vibrancy) would be the set of assassination attempts and plots directed against US presidents during our sample period. Arguably these are exogenous, random events that always result in an injection of uncertainty in markets. Additionally, it is reasonable to assume that the economic impact of this uncertainty should be easier (harder) to assess for investors in (outside) politically vibrant areas.

Using the twelve United States presidential assassination attempts and plots identified by Wikipedia[11] as random events exogenously triggering uncertainty, we repeat the cross-sectional tests separately for "shock" periods (i.e. periods of high levels of political uncertainty) and "normal" (all other) political periods. The former are defined as the periods starting a month prior to the date of an attempt or a plot discovery date and ending 24 months later. The results are shown in Table 11. In Panel A we use clone portfolios formed based on DGTW characteristics, whereas in Panel B we use clone protfolios based on industry and size sorts. The coefficient of the *Clone past return (-1, -1)*, i.e. of the previous month's return of the portfolio with non-zero *CTI3* (or higher *PROX*), is significantly larger in the shock periods' subsample than in the "normal" periods ' subsample in seven out of eight cases. Overall these results lend strong support to the view that our results are not simply triggered by return

[11] See http://en.wikipedia.org/wiki/List_of_United_States_presidential_assassination_attempts_and_plots. Wikipedia identifies 12 assassination attempts and plots during our sample period.

autocorrelation, but rather by slow diffusion of information into prices caused by differential political vibrancy.

*** INSERT TABLE 11 ***

IV.3. Proximity to closest capital

Our measure of proximity to political power is based on the distance from the capital in the same state. However, one could argue that a firm geographically distant from its home-state capital can still be located close to the capital of a different, neighboring state. Thus, such a firm could still be in a politically vibrant geographic area where value-relevant information is generated. This point is valid because the most important political initiatives and new policies are generally introduced at the federal level and can affect firms across state borderlines.

Therefore, in order to account for the aforementioned effect, we re-measure geographic ties with regard to proximity by considering the shortest distance from any surrounding capital. One technical issue in this measure is that we cannot construct an orthogonal-type measure as it was done with the original measure (i.e., residual value from the regression of distance on state, capital, firm, and industry variables) since the firm and the capital city do not have to necessarily be located in the same state. Consequently, we conduct the main tests using the raw shortest distance to any capital. Results are documented in Table 12 where Panels A and B replicate the tests in Tables 6 and 7, respectively. We confirm that return predictability runs from politically vibrant to non-politically supporting the notion that value-relevant information diffuses slowly into prices. Thus, our results are not sensitively altered when we use a proximity-based measure that expands the scope of geographic ties across state lines.

*** INSERT TABLE 12 ***

V. Conclusions

We hypothesize that political vibrancy proxied by geographic ties between firms' headquarter locations and powerful politicians can serve as pathways of value-relevant information flow into stock prices and, consequently, as the basis for return predictability strategies. Essentially, we argue that information related to value-relevant political developments that affect markets, can be assessed in a more straight-forward manner by investors in politically vibrant areas. Hence, this information will be first reflected in the prices of firms located in politically vibrant areas, an effect that can be reinforced by the propensity of local investors to show preference for nearby firms' stocks, i.e., local bias (Coval and Moskowitz, 1999). Investors outside areas characterized by political vibrancy lack the access to the network linking political actors and local citizens which is necessary to enable deciphering value-implications of political information shocks to their local stocks in a timely fashion. Therefore, we hypothesize that these investors' relatively limited ability to process market-related political information can cause stock prices of firms in non-politically vibrant areas to respond to political information shocks with delay relative to their peers from politically vibrant areas.

We utilize a large sample of publicly listed US stocks over a period of 47 years spanning the 1968-2014 period. We develop two measures, one static and one dynamic, of politically vibrant areas as clusters of political information production. The static measure gauges the degree of political vibrancy of firms' headquarter locations by proximity to state capitals where there is a large concentration of political actors and continuous political activity. The dynamic measure of political vibrancy is defined at the state level, by accounting for the extent of representation in the President's cabinet by politicians from that particular state.

Our findings establish that those communities that are designated as politically vibrant are more exposed to political news and more likely to participate in the market. We also show that local bias in institutional investors' equity holdings and local comovement become stronger with political vibrancy, consistent with the notion that politically vibrant areas' markets are more likely to become segmented, a necessary condition for the existence of return predictability effects. Finally, in the main stage of our investigation we provide evidence that spatial variation in political vibrancy is associated with return predictability, in line with the view that value-relevant information flows from stock prices of firms located in politically vibrant areas to those of otherwise similar firms located outside politically vibrant areas. This evidence is derived from a series of return predictability tests using time series and cross-sectional tests utilizing a methodology inspired by the work of Cohen and Lou (2010).

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Table 1
Descriptive Statistics

This table provides descriptive statistics for the sample. *CTI1* = *Level1*; *CTI2* = (1/2)**Level1* + (1/12)**Level2*; and *CTI3* = (1/3)**Level1* + (1/18)**Level2* + (1/33)**Level3*, where *Level1* is an indicator of the home state of the President. *Level2* (*Level3*) is the total number of level 2 (level 3) cabinet members from the home state. Level 1 includes only the President (the most powerful member of the administration). Level 2 includes the vice-President, the "big four" (Secretary of State, Secretary of Treasury, Secretary of Defense, and Attorney General), and the Chief of Staff. Finally, Level 3 includes the other cabinet members (Secretary of Interior, Secretary of Agriculture, Secretary of Commerce, Secretary of Labor, Secretary of Health, Education and Welfare, Secretary of Housing and Urban Development, Secretary of Transportation, US Representative to UN, Chair Council of Economic Advisers, Director of Office of Management and Budget, and Office of Trade Representative). *PROX* = the degree of firm's proximity to state capital. *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. *Convictions* = the Convictions, extracted from the US Department of Justice Public Integrity Section (http://www.usdoj.gov/criminal/pin/). *Dependence on government* = the sum of all procurement contracts of the firms in the state (billion $). Information of procurement contracts is obtained from the Federal Procurement Data System – Next Generation (FPDS-NG). *Voter turnout* = the percentage of eligible voters who cast a ballot in the election. *Close election* = a dummy for the election in which the winner's margin is less than 2%. *Relative capital population* = the ratio of capital population to state population. *County in capital* = a dummy for county located in the capital city. *Community politics* = the average survey score of the community area as in Brown, Ivković, Smith, and Weisbenner (2008). In case we do not have any values for the community, we use the state-level average. *Size* = the natural log of one plus market value of common equity. *B/M* = the ratio of book value equity to market value equity. *Beta* = beta, computed using weekly returns. *Past return (-1, -1)* = one-month stock return in month -1. *Past return (-4, -2)* = three-month stock return from months -4 to -2. *Past return (-12, -1)* = twelve-month return from months -12 to -1. *Turnover* = the average over the year of the monthly trading volume scaled by the number of outstanding shares. *Leverage* = total debt in current liabilities plus total long-term debt, divided by total assets. *ROA* = net income divided by previous-year total assets. *R&D expenditures to sales* = R&D expenditures adjusted by sales. *Advertising expenditures to sales* = Advertising expenditures adjusted by sales. *Dividend yield* = Total dividends paid divided by price at the end of the previous year. *Firm age* = the natural log of one plus the number of years since the stock inclusion in the CRSP database. *Litigation* = a dummy that equals 1 if the lawsuit is filled a given calendar year y, and otherwise equals 0. The Stanford law school maintains the Securities Class Action Clearinghouse that has complied federal class actions related to a security fraud. We obtain litigation data from (http://securities.stanford.edu/fmi/xsl/SCACPUDB/recordlist.xsl). Refer to Appendix 1 for detailed variable descriptions.

Cabinet tie indexes						
	No. of state-years	Mean	Standard deviation	5th percentile	Median	95th percentile
CTI1	2,280	0.020614	0.141346	0	0	0
CTI2	2,280	0.01981	0.086591	0	0	0.083333
CTI3	2,280	0.019431	0.062877	0	0	0.085859
Proximity to state capital						
	No. of firm-years	Mean	Standard deviation	5th percentile	Median	95th percentile
PROX	172,350	11.15717	88.36165	-155.89	19.96079	152.5931
Policy risk						
	No. of state-years	Mean	Standard deviation	5th percentile	Median	95th percentile
PAI	2,280	0.464714	0.272851	0.05	0.458333	0.928571
State variables						
	No. of state-years	Mean	Standard deviation	5th percentile	Median	95th percentile
Convictions	1,670	15.5	21.75634	0	7	63
Dependence on government	1,242	1.153039	3.450611	0	0.026295	6.53746
State population	2,280	14.99883	0.998612	13.34534	15.10437	16.69603
Relative capital population	2,280	0.062371	0.066993	0.006658	0.040138	0.175166

Table 1 (Cont'd)
Descriptive Statistics

County variables						
	No. of county-years	Mean	Standard deviation	5th percentile	Median	95th percentile
Voter turnout at county level	20,039	0.4795	0.1183	0.2837	0.4816	0.6676
Close election at county level	20,039	0.0620	0.2411	0.0000	0.0000	1.0000
County in capital	20,086	0.5805	0.4935	0.0000	1.0000	1.0000

City variables						
	No. of city-years	Mean	Standard deviation	5th percentile	Median	95th percentile
Community politics	19,974	0.4299	0.0500	0.3537	0.4283	0.5241

Panel G: Firm characteristics						
	No. of firm-years	Mean	Standard deviation	5th percentile	Median	95th percentile
Size	172,350	18.6776	2.1276	15.3224	18.5731	22.3599
B/M	172,350	0.8113	0.6681	0.1266	0.6440	2.0913
Beta	172,350	0.8585	0.7519	-0.2167	0.7946	2.2196
Past return (-1, -1)	172,350	0.0164	0.1337	-0.1932	0.0081	0.2491
Past return (-4, -2)	172,350	0.0073	0.2421	-0.3858	0.0000	0.4140
Past return (-12, -1)	172,350	0.1850	0.7479	-0.5936	0.0840	1.2248
Turnover	161,588	0.0928	0.1723	0.0060	0.0458	0.3264
Leverage	171,702	0.1660	0.1729	0.0000	0.1133	0.5120
R&D expenditures to sale	157,189	0.0969	0.4806	0.0000	0.0000	0.2468
Advertising expenditures to sale	157,189	0.0099	0.0246	0.0000	0.0000	0.0511
ROA	158,338	0.0012	0.3916	-0.3221	0.0329	0.1818
Dividend yield	172,284	0.7895	2.4091	0.0000	0.0340	4.0900
Firm age	172,350	2.2751	0.8057	0.6931	2.3026	3.5264
Litigation	89,526	0.0199	0.1397	0.0000	0.0000	0.0000

Table 2
Geographic Ties and Related Characteristics

Panel A compares the Convictions and dependence on government at the state level, while panel B compares litigation status at the firm level for the sub-groups sorted by *CTI3*, and the difference in the Convictions between the no-*CTI3* and the high-*CTI3* groups. States or firms are included in the low-*CTI3* (high-*CTI3*) group if their *CTI3* is lower (higher) than the median value of all non-zero *CTI3*, while the no-*CTI3* group includes states or firms with a value of 0 in *CTI3*. *Convictions* = the Convictions, extracted from the US Department of Justice Public Integrity Section. *Dependence on government* is the sum of all procurement contracts of the firms in the state (billion $). *Litigation* = a dummy that equals 1 if the lawsuit is filled a given calendar year y, and otherwise equals 0. Refer to Appendix 1 for detailed variable descriptions. *** indicates significance at the 1% level.

Panel A: State-level comparison (geographic ties, state corruption, and government dependence)		
	Convictions	*Dependence on government*
CTI3 portfolios		
Zero-*CTI3* states	10.9894	0.7079
Low-*CTI3* states	20.3540	1.8111
High-*CTI3* states	41.0909	3.6635
No – High	-30.1015***	-2.9556***
[*p*-value]	[0.000]	[0.000]

Panel B: Firm-level comparison (geographic ties and the probability of litigation)	
	Litigation
CTI3 portfolios	
Zero-*CTI3* firms	0.0176
Low-*CTI3* firms	0.0193
High-*CTI3* firms	0.0251
High – Zero	0.0075***
[*p*-value]	[0.000]
PROX portfolios	
Low-*PROX* firms	0.0175
Medium-*PROX* firms	0.0185
High-*PROX* firms	0.0238
High – Low	0.063***
[*p*-value]	[0.000]

Table 3
Geographic Ties, Community Politics, and Voter Turnout

Panel A compares the community politics at the community level and the difference between the no-*CTI3* and the high-*CTI3* groups. States or firms are included in the low-*CTI3* (high-*CTI3*) group if their *CTI3* is lower (higher) than the median value of all non-zero *CTI3*, while the no-*CTI3* group includes states or firms with a value of 0 in *CTI3*. *PROX* = the degree of firm's proximity to state capital. *Community politics* = the average survey score of the community area as in Brown, Ivković, Smith, and Weisbenner (2008). In case we do not have any values for the community, we use the state-level average. Panel B reports the regression of voter turnout on election and county variables. *Voter turnout* = the percentage of eligible voters who cast a ballot in the election. *Close election* = a dummy for the election in which the winner's margin is less than 2%. *Relative capital population* = the ratio of capital population to state population. *County in capital* = a dummy for county located in the capital city. Refer to Appendix 1 for detailed variable descriptions. *** and ** indicate significance at the 1% and 5% level, respectively.

Panel A: Comparison of community politics	
CTI3 portfolios	
Zero-*CTI3* firms	0.4258
Low-*CTI3* firms	0.4311
High-*CTI3* firms	0.4366
High – Zero	0.0108***
[*p*-value]	[0.000]
PROX portfolios	
Low-*PROX* firms	0.4304
Medium-*PROX* firms	0.4266
High-*PROX* firms	0.4328
High – Low	0.0024***
[*p*-value]	[0.004]

Panel B: Regression of voter turnout

Dependent variable:	*Voter turnout*		
	[I]	[II]	[III]
CTI3	0.0590***	0.0548***	0.0548***
	(7.22)	(6.72)	(6.72)
Voter turnout (last election)	-0.6133***	-0.6160***	-0.6160***
	(-100.85)	(-101.53)	(-101.53)
Close election at county level	0.0060**	0.0059**	0.0059**
	(2.44)	(2.42)	(2.41)
County population	-0.0274***	-0.0210***	-0.0210***
	(-11.63)	(-8.67)	(-8.68)
Relative capital population		1.0240***	1.0244***
		(10.72)	(10.72)
County in capital			-0.0064
			(-0.65)
Constant	1.0859***	0.9689***	0.9730***
	(38.93)	(32.44)	(31.89)
County-fixed effect	Yes	Yes	Yes
N. of observations	18,821	18,821	18,821
R-squared	0.3646	0.3687	0.3687

Table 4
Institutions' Biased Holdings of Local Equity

Panel A compares *institutions' biased holdings of local equity* at the state level and the difference between the no-*CTI3* and the high-*CTI3* groups. States are included in the low-*CTI3* (high-*CTI3*) group if their *CTI3* is lower (higher) than the median value of all non-zero *CTI3*, while the no-*CTI3* group includes states with a value of 0 in *CTI3*. Panel A also compares *institutions' biased holding of local equity* at the MSA level and the difference between the non-capital MSA and the capital MSA groups. MSAs are included in the capital MSA group if they are the state capital and they are in the non-capital MSA group otherwise. *High CTI3 state dummy* = an indicator that takes a value of 1 if the state is included in the top tercile of *CTI3*, and 0 otherwise. *State population density* = state population divided by state size in square mile. *Number of bordering states* = the number of bordering states around the state. *Capital MSA dummy* = an indicator that takes a value of 1 if the MSA is the state capital and 0 otherwise. *MSA population density* = MSA population divided by MSA size in square mile. Refer to Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Comparison of institutions' biased holding of local equity

CTI3-based comparison (state-level)	
Zero-*CTI3* states	1.0900
Low-*CTI3* states	1.2116
High-*CTI3* states	1.5030
High – Zero	0.4130***
[*p*-value]	[0.000]
PROX-based comparison (MSA-level)	
Non-capital MSA	1.2238
Capital MSA	1.4000
High – Low	0.1762**
[*p*-value]	[0.029]

Panel B: Regression of institutions' biased holding of local equity

	State-level regression	MSA-level regression
Dependent variable:	*institutions' biased holding of local equity (state-level)*	*institutions' biased holding of local equity (MSA-level)*
	[I]	[II]
High CTI3 state dummy	0.3214***	
	(2.96)	
State population density	0.0001	
	(0.54)	
Number of bordering states	-0.0229	
	(-0.92)	
Capital MSA dummy		0.3794***
		(3.78)
MSA population density		0.00005*
		(1.77)
Distance from the next large city		-0.0016*
		(-1.83)
Constant	1.0445***	1.7446***
	(2.96)	(3.20)
Year dummies	Yes	Yes
N. of observations	690	887
R-squared	0.0567	0.0597

Table 5
Local Comovement

Panels A and B report cross-sectional averages of the estimated coefficients (betas) from the individual firms' regression of weekly returns on the Fama-French 4 factors and local returns estimated on annual basis. We classify firms by *CTI3* or *PROX* and compute the averages of betas over the whole sample period for each subsample group. *CTI3* = the third-level cabinet tie index. *PROX* = the degree of firm's proximity to state capital.

$$r_w^i - r_w^f = a_0 + \beta_{market}(r_w^{market} - r_w^f) + s\, SMB_w + h\, HML_w + u\, UMD_w + e_w,$$

$$r_w^i - r_w^f = a_0 + \beta_{market}(r_w^{market} - r_w^f) + \beta_{local}(r_w^{local} - r_w^f) + s\, SMB_w + h\, HML_w + u\, UMD_w + e_w,$$

where r_w^i is an individual firm's weekly return. r_w^f = the one-week Treasury bill rate. r_w^{market} = the value-weighted market return. r_w^{local} = the equally-weighted return of all stocks from the firm's corresponding MSA. *SMB* (small minus big) = the difference each week between the return on small and big firms, while *HML* (high minus low) = the weekly difference of the returns on a portfolio of high book-to-market and low book-to-market firms. *UMD* (up minus down) = the momentum factor computed on a weekly basis as the return differential between a portfolio of winners and a portfolio of losers. We report *t*-statistic values in parentheses testing whether the average value is zero. Panel B reports coefficient estimates from pooled regressions of comovement measure (beta). Refer to Appendix 1 for detailed variable descriptions. *** and ** indicate significance at the 1% and 5% level, respectively.

Panel A: Comparisons of betas			
	Model without local excess returns	Model with local excess returns	
	β_{market}	β_{market}	β_{local}
All firms			
All firms	0.8952***	0.1170***	0.8684***
	(414.00)	(38.28)	(324.98)
CTI3 portfolios			
Zero *CTI3*	0.8655***	0.1279***	0.8548***
	(284.44)	(32.39)	(252.94)
Low *CTI3*	0.8837***	0.1082***	0.8665***
	(189.70)	(17.05)	(151.95)
High *CTI3*	0.9471***	0.1063***	0.8901***
	(234.63)	(16.69)	(158.83)
High – Zero	0.0816***	-0.0216***	0.0353***
	(16.39)	(-3.04)	(5.72)
PROX portfolios			
Low *PROX*	0.8659***	0.1430***	0.8293***
	(232.14)	(28.27)	(190.60)
Medium *PROX*	0.8904***	0.1105***	0.8804***
	(237.25)	(21.52)	(194.12)
High *PROX*	0.9280***	0.0983***	0.8943***
	(247.78)	(17.44)	(180.82)
High – Low	0.0622***	-0.0447***	0.0650***
	(11.75)	(-5.89)	(9.84)

Table 5 (Cont'd)
Local Comovement

Panel C: Cross-sectional regression of local comovement		
Dependent variable: β_{local} from the firms' annual regression of weekly returns	[I]	[II]
CTI3	0.1478***	
	(5.35)	
PROX		0.0004***
		(12.70)
Scaled monthly trading volume	1.2359***	1.2219***
	(42.09)	(41.62)
Firm age	-0.0760***	-0.0736***
	(-21.19)	(-20.51)
Size	-0.1908***	-0.1926***
	(-109.77)	(-110.55)
B/M	-0.0597***	-0.0605***
	(-12.79)	(-12.95)
Leverage	0.2356***	0.2420***
	(17.29)	(17.76)
3-year R&D expenditure	0.0001***	0.0001***
	(2.73)	(2.68)
3-year advertising expenditure	0.0040**	0.0040**
	(2.15)	(2.15)
3-year ROA	-0.2429***	-0.2414***
	(-32.76)	(-32.58)
Dividend yield	0.0257***	0.0260***
	(20.24)	(20.49)
Past return (-12, -1)	-0.0423***	-0.0416***
	(-11.61)	(-11.44)
Constant	4.7274***	4.7731***
	(87.62)	(88.35)
Year dummies	Yes	Yes
Industry dummies	Yes	Yes
State dummies	Yes	Yes
N. of observations	143,720	143,720
R-squared	0.1614	0.1622

Table 6
Clone Stock Returns of Portfolios Classified by Size, Value, and Past Return

This table reports excess returns and alphas from the regressions of the monthly excess returns in the 1-factor, 3-factor, and 4-factor models. At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. In Panel A, portfolios with zero *CTI3* values (no cabinet ties) are classified into the decile groups based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same characteristic sub-samples. In Panel B, portfolios with low *PROX* values (longer proximity) are classified into the decile groups based on the previous month returns of portfolios with high *PROX* values obtained from the same characteristic sub-samples. *CTI3* = the third-level cabinet tie index. *PROX* = the degree of firm's proximity to state capital. Refer to the Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Portfolios based on the third-level cabinet tie index (*CTI3*)

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0054*	-0.0007	-0.0024	0.0005	0.0044	-0.0016	-0.0032**	-0.0004
	(1.68)	(-0.32)	(-1.38)	(0.32)	(1.42)	(-0.79)	(-1.98)	(-0.27)
2	0.0041	-0.0013	-0.0032***	-0.0016	0.0051*	-0.0004	-0.0021*	-0.0004
	(1.56)	(-0.83)	(-2.62)	(-1.29)	(1.88)	(-0.25)	(-1.70)	(-0.30)
3	0.0049**	-0.0002	-0.0022**	-0.0008	0.0051**	-0.0001	-0.0024**	-0.0013
	(2.02)	(-0.15)	(-2.09)	(-0.76)	(2.07)	(-0.04)	(-2.26)	(-1.23)
4	0.0073***	0.0022	-0.0003	0.0010	0.0064***	0.0015	-0.0007	0.0005
	(3.02)	(1.63)	(-0.27)	(1.10)	(2.71)	(1.08)	(-0.69)	(0.50)
5	0.0066***	0.0017	-0.0007	-0.0002	0.0067***	0.0019	-0.0009	0.00004
	(2.92)	(1.43)	(-0.95)	(-0.21)	(2.93)	(1.45)	(-1.10)	(0.05)
6	0.0082***	0.0033***	0.0011	0.0018**	0.0091***	0.0041***	0.0019**	0.0028***
	(3.58)	(2.67)	(1.43)	(2.45)	(3.98)	(3.43)	(2.39)	(3.51)
7	0.0098***	0.0051***	0.0026***	0.0033***	0.0092***	0.0043***	0.0021***	0.0026***
	(4.34)	(3.96)	(3.34)	(4.25)	(4.09)	(3.71)	(2.97)	(3.74)
8	0.0112***	0.0062***	0.0039***	0.0044***	0.0098***	0.0049***	0.0025***	0.0029***
	(4.72)	(4.60)	(4.32)	(4.80)	(4.18)	(3.66)	(2.97)	(3.38)
9	0.0096***	0.0046***	0.0025**	0.0034***	0.0104***	0.0055***	0.0033***	0.0042***
	(3.89)	(3.05)	(2.25)	(3.08)	(4.35)	(3.88)	(3.33)	(4.20)
10 (high)	0.0136***	0.0083***	0.0058***	0.0072***	0.0138***	0.0084***	0.0061***	0.0077***
	(4.91)	(4.55)	(4.20)	(5.17)	(4.94)	(4.57)	(4.23)	(5.38)
High – low	0.0082***	0.0090***	0.0082***	0.0066***	0.0094***	0.0100***	0.0093***	0.0081***
	(3.62)	(3.97)	(3.60)	(2.88)	(4.28)	(4.57)	(4.17)	(3.58)

Panel B: Portfolios based on the degree of geographic proximity to state capital (*PROX*)

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0038	-0.0023	-0.0043**	-0.0012	0.0029	-0.0032	-0.0052***	-0.0021
	(1.21)	(-1.10)	(-2.49)	(-0.73)	(0.91)	(-1.59)	(-3.09)	(-1.34)
2	0.0040	-0.0016	-0.0040***	-0.0022*	0.0042	-0.0015	-0.0037***	-0.0020*
	(1.43)	(-0.96)	(-3.21)	(-1.84)	(1.49)	(-0.90)	(-3.07)	(-1.73)
3	0.0045*	-0.0009	-0.0030***	-0.0014	0.0043*	-0.0010	-0.0035***	-0.0020*
	(1.77)	(-0.61)	(-2.95)	(-1.42)	(1.68)	(-0.71)	(-3.32)	(-1.89)
4	0.0058**	0.0008	-0.0015	-0.0005	0.0061**	0.0011	-0.0011	0.0001
	(2.44)	(0.58)	(-1.60)	(-0.53)	(2.57)	(0.83)	(-1.23)	(0.10)
5	0.0063***	0.0013	-0.0010	-0.0001	0.0067***	0.0018	-0.0006	0.0004
	(2.72)	(1.06)	(-1.32)	(-0.10)	(2.94)	(1.47)	(-0.77)	(0.56)
6	0.0078***	0.0030**	0.0007	0.0014*	0.0074***	0.0025**	0.0003	0.0008
	(3.49)	(2.48)	(0.90)	(1.80)	(3.24)	(2.05)	(0.35)	(1.13)
7	0.0094***	0.0045***	0.0022***	0.0029***	0.0090***	0.0040***	0.0016**	0.0022***
	(4.10)	(3.66)	(2.74)	(3.70)	(3.90)	(3.27)	(2.01)	(2.73)
8	0.0103***	0.0054***	0.0030***	0.0035***	0.0102***	0.0052***	0.0030***	0.0035***
	(4.35)	(3.96)	(3.41)	(3.85)	(4.39)	(4.12)	(3.65)	(4.21)
9	0.0108***	0.0056***	0.0033***	0.0045***	0.0122***	0.0070***	0.0047***	0.0057***
	(4.18)	(3.52)	(2.86)	(3.98)	(4.73)	(4.39)	(4.05)	(4.95)
10 (high)	0.0119***	0.0066***	0.0040***	0.0059***	0.0118***	0.0064***	0.0039***	0.0060***
	(4.29)	(3.60)	(2.88)	(4.27)	(4.24)	(3.54)	(2.85)	(4.54)
High – low	0.0081***	0.0089***	0.0083***	0.0071***	0.0089***	0.0096***	0.0091***	0.0081***
	(3.63)	(4.00)	(3.68)	(3.08)	(4.17)	(4.50)	(4.18)	(3.68)

Table 7
Clone Stock Returns of Portfolios Classified by Industry and Policy Uncertainty

This table reports excess returns and alphas from the regressions of the monthly excess returns in the 1-factor, 3-factor, and 4-factor models. At the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of *PAI*, where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. In Panel A, portfolios with zero *CTI3* values (no cabinet ties) are classified into the decile groups based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same characteristic sub-samples. In Panel B, portfolios with low *PROX* values (longer proximity) are classified into the decile groups based on the previous month returns of portfolios with high *PROX* values obtained from the same characteristic sub-samples. *CTI3* = the third-level cabinet tie index. *PROX* = the degree of firm's proximity to state capital. Refer to the Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Portfolios based on the third-level cabinet tie index (*CTI3*)

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0036	-0.0023	-0.0043***	-0.0024*	0.0036	-0.0022	-0.0042***	-0.0022*
	(1.24)	(-1.30)	(-3.15)	(-1.82)	(1.27)	(-1.24)	(-3.28)	(-1.81)
2	0.0028	-0.0028*	-0.0052***	-0.0031**	0.0044	-0.0010	-0.0031**	-0.0007
	(1.02)	(-1.70)	(-4.07)	(-2.56)	(1.64)	(-0.64)	(-2.49)	(-0.63)
3	0.0036	-0.0017	-0.0038***	-0.0021**	0.0054**	0.0001	-0.0020*	-0.0006
	(1.42)	(-1.15)	(-3.46)	(-1.97)	(2.09)	(0.08)	(-1.86)	(-0.54)
4	0.0055**	0.0003	-0.0022**	-0.0006	0.0065***	0.0013	-0.0010	0.0001
	(2.18)	(0.20)	(-2.10)	(-0.59)	(2.63)	(0.93)	(-1.16)	(0.06)
5	0.0079***	0.0028**	0.0006	0.0017*	0.0074***	0.0022	-0.0003	0.0009
	(3.22)	(1.97)	(0.65)	(1.72)	(3.02)	(1.62)	(-0.32)	(1.01)
6	0.0092***	0.0041***	0.0017*	0.0030***	0.0090***	0.0040***	0.0017*	0.0026***
	(3.79)	(3.00)	(1.76)	(3.22)	(3.74)	(2.89)	(1.73)	(2.70)
7	0.0107***	0.0055***	0.0031***	0.0038***	0.0084***	0.0034**	0.0012	0.0019**
	(4.35)	(3.99)	(3.37)	(4.19)	(3.55)	(2.57)	(1.33)	(2.05)
8	0.0117***	0.0065***	0.0046***	0.0048***	0.0117***	0.0063***	0.0041***	0.0046***
	(4.76)	(4.68)	(4.62)	(4.73)	(4.59)	(4.41)	(4.23)	(4.72)
9	0.0116***	0.0065***	0.0044***	0.0049***	0.0117***	0.0065***	0.0047***	0.0050***
	(4.68)	(4.42)	(4.49)	(4.94)	(4.78)	(4.83)	(4.77)	(4.98)
10 (high)	0.0154***	0.0100***	0.0085***	0.0090***	0.0143***	0.0089***	0.0070***	0.0081***
	(5.61)	(5.73)	(6.71)	(6.96)	(5.24)	(5.16)	(5.53)	(6.40)
High – low	0.0118***	0.0123***	0.0128***	0.0114***	0.0107***	0.0111***	0.0111***	0.0103***
	(6.14)	(6.36)	(6.55)	(5.78)	(6.37)	(6.57)	(6.50)	(5.93)

Panel B: Portfolios based on the degree of geographic proximity to state capital (*PROX*)

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0011	-0.0047***	-0.0070***	-0.0042***	0.0011	-0.0049***	-0.0069***	-0.0042***
	(0.38)	(-2.59)	(-4.87)	(-3.14)	(0.37)	(-2.88)	(-5.57)	(-3.73)
2	0.0024	-0.0033**	-0.0052***	-0.0033***	0.0045*	-0.0009	-0.0031**	-0.0006
	(0.86)	(-2.06)	(-4.35)	(-2.84)	(1.67)	(-0.57)	(-2.43)	(-0.53)
3	0.0041	-0.0014	-0.0039***	-0.0018*	0.0056**	0.0003	-0.0022**	-0.0008
	(1.53)	(-0.91)	(-3.36)	(-1.68)	(2.17)	(0.20)	(-2.01)	(-0.71)
4	0.0047*	-0.0004	-0.0030***	-0.0014	0.0054**	0.0002	-0.0019*	-0.0004
	(1.91)	(-0.28)	(-2.92)	(-1.44)	(2.18)	(0.16)	(-1.92)	(-0.46)
5	0.0077***	0.0025*	0.0001	0.0018*	0.0069***	0.0018	-0.0006	0.0004
	(3.12)	(1.80)	(0.15)	(1.88)	(2.84)	(1.30)	(-0.63)	(0.46)
6	0.0087***	0.0036***	0.0013	0.0025***	0.0085***	0.0034**	0.0011	0.0019**
	(3.65)	(2.76)	(1.43)	(2.77)	(3.55)	(2.58)	(1.29)	(2.25)
7	0.0098***	0.0046***	0.0021**	0.0031***	0.0103***	0.0052***	0.0028***	0.0037***
	(3.94)	(3.23)	(2.24)	(3.30)	(4.24)	(3.79)	(2.88)	(3.87)
8	0.0118***	0.0067***	0.0040***	0.0047***	0.0117***	0.0066***	0.0045***	0.0051***
	(4.80)	(4.70)	(4.11)	(4.73)	(4.77)	(4.64)	(4.94)	(5.49)
9	0.0134***	0.0081***	0.0061***	0.0068***	0.0112***	0.0057***	0.0031***	0.0041***
	(5.25)	(5.44)	(5.68)	(6.30)	(4.26)	(3.80)	(3.05)	(4.02)
10 (high)	0.0135***	0.0080***	0.0062***	0.0071***	0.0127***	0.0072***	0.0051***	0.0062***
	(4.89)	(4.61)	(4.88)	(5.54)	(4.70)	(4.38)	(4.27)	(5.23)
High – low	0.0124***	0.0127***	0.0132***	0.0114***	0.0116***	0.0121***	0.0119***	0.0104***
	(6.57)	(6.76)	(6.91)	(5.94)	(7.61)	(7.96)	(7.71)	(6.73)

Table 8
Cross-sectional Tests of Stock Returns

At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. Alternatively, at the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of local politicians' party alignment (*PAI*), where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. Portfolios with zero *CTI3* values are ranked based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same sub-samples, while portfolios with lower *PROX* values are ranked based on the previous month returns of portfolios with higher *PROX* values obtained from the same sub-samples. *Pair past return (-1, -1)* = the previous month return of portfolio with non-zero *CTI3* (or higher *PROX*) values in the same sub-sample. *Clone past return (-1, -1)* = the previous month return of portfolio with zero *CTI3* (or lower *PROX*) values in the same sub-sample. *Past return (-1, -1)* = the portfolio average of previous month return. *Past return (-4, -2)* = the portfolio average of three-month return from month -4 to month -2. *Size* = the portfolio average of *size*. *B/M* = the portfolio average of *B/M*. *Turnover* = the portfolio average of the monthly mean turnover in the previous year. Refer to Appendix 1 for detailed variable descriptions. *** and ** indicate significance at the 1% and 5% level, respectively.

Dependent variable: *Monthly return*	Clone portfolios are matched by size, value, and past return				Clone portfolios are matched by industry and policy risk			
	CTI3-based portfolios		*PROX*-based portfolios		*CTI3*-based portfolios		*PROX*-based portfolios	
	Equally weighted returns	Value weighted returns	Equally weighted returns	Value weighted returns	Equally weighted returns	Value weighted returns	Equally weighted returns	Value weighted returns
	[I]	[II]	[III]	[IV]	[V]	[VI]	[VII]	[VIII]
Pair past return (-1, -1)	0.0213***	0.0256***	0.0269***	0.0284***	0.0303***	0.0238***	0.0316***	0.0286***
	(3.51)	(4.09)	(4.98)	(5.20)	(4.96)	(4.25)	(5.30)	(5.34)
Past return (-1, -1)	-0.0401***	-0.0385***	-0.0349***	-0.0365***	-0.0089	-0.0252***	-0.0230***	-0.0232***
	(-5.52)	(-5.29)	(-4.87)	(-5.24)	(-0.98)	(-3.11)	(-2.61)	(-2.74)
Past return (-4, -2)	0.0064	0.0061	0.0040	0.0056	0.0182***	0.0136**	0.0158***	0.0060
	(1.49)	(1.40)	(0.94)	(1.28)	(3.43)	(2.46)	(3.09)	(1.08)
Size	-0.0004	-0.0003	-0.0004	-0.0003	-0.0001	0.0003	-0.0012**	-0.0007
	(-0.76)	(-0.75)	(-0.90)	(-0.76)	(-0.23)	(0.73)	(-2.05)	(-1.41)
B/M	0.0009	0.0005	0.0004	-0.0003	0.0010	0.0025	0.0001	0.0008
	(1.02)	(0.57)	(0.41)	(-0.31)	(0.58)	(1.33)	(0.04)	(0.38)
Turnover	-0.0397**	-0.0269	-0.0659***	-0.0608***	-0.0180	-0.0272	-0.0545**	-0.0432***
	(-2.27)	(-1.34)	(-3.82)	(-3.06)	(-0.96)	(-1.65)	(-2.56)	(-2.60)
Constant	0.0185**	0.0173**	0.0197**	0.0180**	0.0127	0.0016	0.0339***	0.0251**
	(1.98)	(2.01)	(2.14)	(2.15)	(1.09)	(0.15)	(2.81)	(2.26)
Number of observations (portfolio-years)	65,524	66,764	66,315	67,176	48,476	48,822	49,481	49,617
Number of months	564	564	564	564	564	564	564	564
Average R-squared	0.2265	0.2165	0.2240	0.2154	0.1980	0.1986	0.1963	0.2003

Table 9
Cross-sectional Tests of Forecast Revisions

At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. Alternatively, at the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of local politicians' party alignment (*PAI*), where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. Portfolios with zero *CTI3* values are ranked based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same sub-samples, while portfolios with lower *PROX* values are ranked based on the previous month returns of portfolios with higher *PROX* values obtained from the same sub-samples. *Pair past return (-1, -1)* = the previous month return of portfolio with non-zero *CTI3* (or higher *PROX*) values in the same sub-sample. *Clone past return (-1, -1)* = the previous month return of portfolio with zero *CTI3* (or lower *PROX*) values in the same sub-sample. *Past return (-1, -1)* = the portfolio average of previous month return. *Past return (-4, -2)* = the portfolio average of three-month return from month -4 to month -2. *Size* = the portfolio average of *size*. *B/M* = the portfolio average of *B/M*. *Turnover* = the portfolio average of the monthly mean turnover in the previous year. Refer to Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Dependent variable: *Forecast revisions*	Clone portfolios are matched by size, value, and past return				Clone portfolios are matched by industry and policy risk			
	CTI3-based portfolios		*PROX*-based portfolios		*CTI3*-based portfolios		*PROX*-based portfolios	
	Equally weighted revisions	Value weighted revisions	Equally weighted revisions	Value weighted revisions	Equally weighted revisions	Value weighted revisions	Equally weighted revisions	Value weighted revisions
	[I]	[II]	[III]	[IV]	[V]	[VI]	[VII]	[VIII]
Pair past revision	0.0208**	0.0511***	0.0250***	0.0489***	0.0215***	0.0136*	0.0213***	0.0243***
	(2.25)	(5.93)	(2.90)	(6.55)	(2.59)	(1.78)	(2.79)	(3.58)
Past revision	-0.0070	0.0125	-0.0240**	0.0279***	-0.0307***	-0.0436***	-0.0266**	-0.0259**
	(-0.72)	(1.09)	(-2.44)	(2.59)	(-2.92)	(-3.19)	(-2.56)	(-2.11)
Past return (-1, -1)	0.1684***	0.0247***	0.1623***	0.0232***	0.0847***	0.0378***	0.1337***	0.0469***
	(7.43)	(6.80)	(7.51)	(7.16)	(5.11)	(6.18)	(7.80)	(6.79)
Past return (-4, -2)	0.1241***	0.0208***	0.1282***	0.0182***	0.0598***	0.0289***	0.0517***	0.0230***
	(12.99)	(13.71)	(14.10)	(12.78)	(6.33)	(8.11)	(5.34)	(6.01)
Size	0.0019***	0.0004***	0.0024***	0.0004***	0.0003	0.0007***	0.0008	0.0006***
	(2.95)	(2.83)	(3.90)	(2.81)	(0.45)	(2.98)	(0.96)	(2.63)
B/M	-0.0131***	-0.0019***	-0.0116***	-0.0022***	-0.0068**	-0.0058***	-0.0091***	-0.0046***
	(-6.43)	(-4.78)	(-5.12)	(-5.71)	(-2.09)	(-4.66)	(-2.76)	(-2.87)
Turnover	-0.0698***	-0.0296***	-0.0422	-0.0267***	-0.0193	-0.0046	0.0153	-0.0045
	(-2.94)	(-4.51)	(-1.64)	(-3.41)	(-0.72)	(-0.54)	(0.68)	(-0.59)
Constant	-0.0262**	-0.0048**	-0.0420***	-0.0044**	0.0021	-0.0121**	-0.0082	-0.0101*
	(-2.04)	(-2.10)	(-3.24)	(-1.99)	(0.14)	(-2.25)	(-0.49)	(-1.87)
Number of observations (portfolio-years)	27,334	44,628	28,222	44,913	22,895	32,409	23,775	33,013
Number of months	372	372	372	372	372	372	372	372
Average R-squared	0.1974	0.1553	0.1923	0.1496	0.1651	0.1554	0.1676	0.1456

Table 10
Firm Size and Clone Stock Returns

This table reports difference in excess returns and in alphas between the highest and lowest return decile groups from the regressions of the monthly excess returns for tercile groups of firm size. In Panel A, At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. In Panel B, at the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of *PAI*, where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. In the first test of each panel, portfolios with zero *CTI3* values (no cabinet ties) are classified into the decile groups based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same characteristic sub-samples. In the second test of each panel, portfolios with low *PROX* values (longer proximity) are classified into the decile groups based on the previous month returns of portfolios with high *PROX* values obtained from the same characteristic sub-samples. *CTI3* = the third-level cabinet tie index. *PROX* = the degree of firm's proximity to state capital. Refer to the Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Table 10 (Cont'd)
Firm Size and Clone Stock Returns

	Equally weighted returns				Value weighted returns			
	Diff. in Excess returns (High - low)	Diff. in 1-Factor alpha (High - low)	Diff. in 3-Factor alpha (High - low)	Diff. in 4-Factor alpha (High - low)	Diff. in Excess returns (High - low)	Diff. in 1-Factor alpha (High - low)	Diff. in 3-Factor alpha (High - low)	Diff. in 4-Factor alpha (High - low)
Panel A: Clone portfolios are matched by size, value, and past return								
Portfolios based on the third-level cabinet tie index (*CTI3*)								
Small-size firms	0.0055*	0.0054*	0.0057*	0.0054*	0.0057*	0.0057*	0.0058*	0.0058*
	(1.93)	(1.86)	(1.94)	(1.81)	(1.89)	(1.87)	(1.89)	(1.86)
Medium-size firms	0.0057**	0.0057**	0.0059**	0.0061**	0.0059**	0.0056**	0.0055**	0.0056**
	(2.18)	(2.17)	(2.18)	(2.23)	(2.23)	(2.12)	(2.04)	(2.03)
Large-size firms	0.0076***	0.0072***	0.0074***	0.0069**	0.0067**	0.0066**	0.0064**	0.0059**
	(2.82)	(2.66)	(2.70)	(2.45)	(2.48)	(2.40)	(2.30)	(2.07)
Large – Small	0.0021	0.0019	0.0018	0.0015	0.0011	0.0010	0.0007	0.0001
	(0.63)	(0.57)	(0.54)	(0.45)	(0.31)	(0.29)	(0.20)	(0.04)
Portfolios based on the degree of geographic proximity to state capital (*PROX*)								
Small-size firms	0.0045	0.0043	0.0036	0.0034	0.0013	0.0015	0.0012	0.0013
	(1.51)	(1.44)	(1.18)	(1.09)	(0.44)	(0.50)	(0.40)	(0.44)
Medium-size firms	0.0102***	0.0101***	0.0102***	0.0103***	0.0100***	0.0101***	0.0102***	0.0101***
	(3.67)	(3.58)	(3.59)	(3.55)	(3.65)	(3.65)	(3.61)	(3.52)
Large-size firms	0.0081***	0.0078***	0.0081***	0.0073**	0.0088***	0.0090***	0.0089***	0.0084***
	(3.01)	(2.85)	(2.91)	(2.58)	(3.29)	(3.31)	(3.22)	(3.00)
Large – Small	0.0036	0.0035	0.0045	0.0039	0.0075	0.0076**	0.0077**	0.0071**
	(1.07)	(1.00)	(1.29)	(1.10)	(2.25)	(2.24)	(2.25)	(2.04)

Table 10 (Cont'd)
Firm Size and Clone Stock Returns

	Equally weighted returns				Value weighted returns			
	Diff. in Excess returns (High - low)	Diff. in 1-Factor alpha (High - low)	Diff. in 3-Factor alpha (High - low)	Diff. in 4-Factor alpha (High - low)	Diff. in Excess returns (High - low)	Diff. in 1-Factor alpha (High - low)	Diff. in 3-Factor alpha (High - low)	Diff. in 4-Factor alpha (High - low)
Panel B: Clone portfolios are matched by industry and policy risk								
Portfolios based on the third-level cabinet tie index (*CTI3*)								
Small-size firms	0.0057*	0.0056*	0.0057*	0.0061**	0.0065**	0.0067**	0.0076***	0.0076***
	(1.93)	(1.88)	(1.89)	(1.98)	(2.35)	(2.38)	(2.68)	(2.62)
Medium-size firms	0.0101***	0.0100***	0.0096***	0.0098***	0.0132***	0.0132***	0.0130***	0.0129***
	(3.73)	(3.66)	(3.47)	(3.45)	(4.86)	(4.81)	(4.66)	(4.55)
Large-size firms	0.0126***	0.0128***	0.0126***	0.0125***	0.0119***	0.0119***	0.0116***	0.0110***
	(4.98)	(5.02)	(4.88)	(4.76)	(5.16)	(5.09)	(4.92)	(4.60)
Large – Small	0.0069*	0.0071**	0.0068*	0.0064*	0.0054	0.0051	0.0039	0.0034
	(1.95)	(1.99)	(1.89)	(1.73)	(1.59)	(1.49)	(1.14)	(0.96)
Portfolios based on the degree of geographic proximity to state capital (*PROX*)								
Small-size firms	0.0047	0.0047	0.0054*	0.0046	0.0079***	0.0080***	0.0081***	0.0076***
	(1.58)	(1.59)	(1.80)	(1.51)	(2.88)	(2.90)	(2.87)	(2.65)
Medium-size firms	0.0101***	0.0099***	0.0100***	0.0102***	0.0104***	0.0103***	0.0103***	0.0105***
	(3.93)	(3.79)	(3.77)	(3.79)	(4.13)	(4.04)	(3.98)	(3.99)
Large-size firms	0.0124***	0.0121***	0.0125***	0.0127***	0.0101***	0.0101***	0.0100***	0.0100***
	(5.18)	(5.01)	(5.11)	(5.08)	(4.58)	(4.49)	(4.41)	(4.33)
Large – Small	0.0077**	0.0074**	0.0071*	0.0081**	0.0023	0.0020	0.0019	0.0024
	(2.10)	(1.99)	(1.88)	(2.11)	(0.67)	(0.60)	(0.56)	(0.69)

Table 11
Political Shocks and Information Flow

The cross-sectional test of stock returns are conducted for two sets of time periods. The shock periods include the months (-1, +23) around presidential assassination attempts, and other months are included in the normal periods. At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. Alternatively, at the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of local politicians' party alignment (*PAI*), where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. Portfolios with zero *CTI3* values are ranked based on the previous month returns of portfolios with non-zero *CTI3* values obtained from the same sub-samples, while portfolios with lower *PROX* values are ranked based on the previous month returns of portfolios with higher *PROX* values obtained from the same sub-samples. *Pair past return (-1, -1)* = the previous month return of portfolio with non-zero *CTI3* (or higher *PROX*) values in the same sub-sample. *Clone past return (-1, -1)* = the previous month return of portfolio with zero *CTI3* (or lower *PROX*) values in the same sub-sample. *Past return (-1, -1)* = the portfolio average of previous month return. *Past return (-4, -2)* = the portfolio average of three-month return from month -4 to month -2. *Size* = the portfolio average of *size*. *B/M* = the portfolio average of *B/M*. *Turnover* = the portfolio average of the monthly mean turnover in the previous year. Refer to Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Table 11 (Cont'd)
Political Shocks and Information Flow

	Clone portfolios are matched by size, value, and past return							
	CTI3-based portfolios				*PROX*-based portfolios			
Dependent variable: *Monthly return*	Equally weighted returns		Value weighted returns		Equally weighted returns		Value weighted returns	
	Shock periods	Normal periods	Shock periods	Normal periods	Shock periods	Normal periods	Shock periods	Normal periods
	[I]	[II]	[III]	[IV]	[V]	[VI]	[VII]	[VIII]
Pair past return (-1, -1)	0.0351***	0.0140*	0.0318***	0.0224***	0.0383***	0.0208***	0.0457***	0.0191***
	(3.59)	(1.81)	(3.15)	(2.81)	(4.39)	(3.04)	(5.30)	(2.75)
Past return (-1, -1)	-0.0512***	-0.0342***	-0.0489***	-0.0329***	-0.0435***	-0.0303***	-0.0454***	-0.0319***
	(-4.24)	(-3.76)	(-3.99)	(-3.64)	(-3.51)	(-3.45)	(-3.86)	(-3.67)
Past return (-4, -2)	0.0050	0.0071	0.0068	0.0057	0.0053	0.0033	0.0047	0.0060
	(0.72)	(1.31)	(0.98)	(1.03)	(0.82)	(0.60)	(0.70)	(1.07)
Size	0.0001	-0.0006	0.0001	-0.0005	-0.0001	-0.0006	0.0001	-0.0005
	(0.18)	(-0.96)	(0.17)	(-0.97)	(-0.14)	(-0.93)	(0.14)	(-0.96)
B/M	0.0021	0.0002	0.0015	-0.00002	0.0004	0.0003	-0.0003	-0.0003
	(1.63)	(0.17)	(1.07)	(-0.02)	(0.28)	(0.30)	(-0.20)	(-0.24)
Turnover	-0.0267	-0.0466**	-0.0018	-0.0402**	-0.0962***	-0.0498***	-0.0972**	-0.0413**
	(-0.72)	(-2.57)	(-0.04)	(-2.00)	(-2.75)	(-2.65)	(-2.20)	(-2.14)
Constant	0.0075	0.0244*	0.0079	0.0223**	0.0136	0.0230*	0.0118	0.0213*
	(0.56)	(1.96)	(0.61)	(1.98)	(1.08)	(1.84)	(0.96)	(1.93)
Test: $\beta_{1,crisis} - \beta_{1,normal}$	0.0211**		0.0094		0.0175*		0.0266***	
[p-value]	[0.049]		[0.237]		[0.062]		[0.010]	
Number of observations (portfolio-years)	22,475	43,049	23,196	43,568	22,858	43,457	23,399	43,777
Number of months	196	368	196	368	196	368	196	368
Average R-squared	0.2207	0.2296	0.2076	0.2212	0.2088	0.2321	0.2023	0.2224

Table 11 (Cont'd)
Political Shocks and Information Flow

Dependent variable: *Monthly return*	Clone portfolios are matched by industry and policy risk							
	CTI3-based portfolios				*PROX*-based portfolios			
	Equally weighted returns		Value weighted returns		Equally weighted returns		Value weighted returns	
	Shock periods	Normal periods	Shock periods	Normal periods	Shock periods	Normal periods	Shock periods	Normal periods
	[I]	[II]	[III]	[IV]	[V]	[VI]	[VII]	[VIII]
Pair past return (-1, -1)	0.0313***	0.0298***	0.0362***	0.0172**	0.0277**	0.0337***	0.0422***	0.0213***
	(3.16)	(3.84)	(3.98)	(2.43)	(2.54)	(4.75)	(4.39)	(3.34)
Past return (-1, -1)	-0.0262*	0.0002	-0.0294**	-0.0229**	-0.0206	-0.0243**	-0.0296*	-0.0198*
	(-1.81)	(0.02)	(-2.10)	(-2.31)	(-1.33)	(-2.26)	(-1.94)	(-1.95)
Past return (-4, -2)	0.0321***	0.0108	0.0184**	0.0111	0.0187**	0.0143**	0.0026	0.0078
	(4.18)	(1.55)	(2.13)	(1.55)	(2.28)	(2.19)	(0.28)	(1.12)
Size	0.0004	-0.0004	0.0014*	-0.0002	-0.0006	-0.0015**	-0.0002	-0.0010
	(0.44)	(-0.58)	(1.80)	(-0.40)	(-0.66)	(-2.02)	(-0.21)	(-1.55)
B/M	0.0030	-0.0001	0.0038	0.0017	0.0008	-0.0003	0.0024	-0.00004
	(1.10)	(-0.06)	(1.24)	(0.75)	(0.27)	(-0.12)	(0.71)	(-0.01)
Turnover	-0.0158	-0.0192	-0.0271	-0.0272	-0.1116**	-0.0241	-0.0815**	-0.0227
	(-0.40)	(-0.97)	(-0.78)	(-1.59)	(-2.41)	(-1.13)	(-2.13)	(-1.50)
Constant	0.0004	0.0192	-0.0232	0.0147	0.0216	0.0404***	0.0145	0.0307**
	(0.02)	(1.30)	(-1.30)	(1.10)	(1.14)	(2.60)	(0.83)	(2.15)
Test: $\beta_{1,crisis} - \beta_{1,normal}$	0.0015		0.0190*		-0.0060		0.0209**	
[p-value]	[0.453]		[0.053]		[0.316]		[0.031]	
Number of observations (portfolio-years)	17,257	31,219	17,457	31,365	17,384	32,097	17,472	32,145
Number of months	196	368	196	368	196	368	196	368
Average R-squared	0.1875	0.2035	0.1878	0.2043	0.1933	0.1978	0.2039	0.1984

Table 12
Proximity to the Closest Capital

This table reports excess returns and alphas from the regressions of the monthly excess returns in the 1-factor, 3-factor, and 4-factor models. In Panel A, at the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. In Panel B, at the beginning of every calendar month, all firms are classified into 147 sub-samples based on the Fama-French 49 industries and the terciles of *PAI*, where *PAI* = the degree of party affiliation alignment with the President's party among the state's leading politicians. Portfolios with low *PROX* values (longer proximity) are classified into the decile groups based on the previous month returns of portfolios with high *PROX* values obtained from the same characteristic sub-samples, where *PROX* = the degree of firm's proximity to state capital. Refer to the Appendix 1 for detailed variable descriptions. ***, ** and * indicate significance at the 1%, 5% and 10% level, respectively.

Panel A: Clone stock returns of portfolios classified by size, value, and past return

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0036	-0.0026	-0.0044***	-0.0014	0.0033	-0.0029	-0.0045***	-0.0019
	(1.13)	(-1.29)	(-2.64)	(-0.89)	(1.07)	(-1.48)	(-2.92)	(-1.29)
2	0.0042	-0.0017	-0.0037***	-0.0017	0.0042	-0.0017	-0.0035**	-0.0012
	(1.44)	(-0.99)	(-2.74)	(-1.32)	(1.45)	(-0.96)	(-2.55)	(-0.92)
3	0.0047*	-0.0007	-0.0029***	-0.0015	0.0050*	-0.0004	-0.0026**	-0.0013
	(1.81)	(-0.49)	(-2.81)	(-1.44)	(1.93)	(-0.30)	(-2.40)	(-1.19)
4	0.0069***	0.0015	-0.0007	0.0004	0.0065***	0.0013	-0.0011	0.0001
	(2.75)	(1.12)	(-0.78)	(0.41)	(2.62)	(0.92)	(-1.17)	(0.10)
5	0.0069***	0.0020*	-0.0002	0.0006	0.0071***	0.0019	-0.0005	0.0007
	(3.03)	(1.65)	(-0.28)	(0.75)	(2.97)	(1.53)	(-0.64)	(0.83)
6	0.0075***	0.0025**	0.0003	0.0012	0.0076***	0.0026**	0.0005	0.0011
	(3.27)	(2.12)	(0.45)	(1.64)	(3.34)	(2.26)	(0.60)	(1.41)
7	0.0096***	0.0044***	0.0022***	0.0029***	0.0086***	0.0035***	0.0012	0.0015*
	(4.03)	(3.57)	(2.82)	(3.61)	(3.64)	(2.82)	(1.59)	(1.94)
8	0.0099***	0.0048***	0.0025***	0.0032***	0.0103***	0.0051***	0.0029***	0.0037***
	(4.11)	(3.59)	(2.87)	(3.66)	(4.24)	(3.85)	(3.25)	(4.16)
9	0.0104***	0.0049***	0.0027**	0.0040***	0.0116***	0.0063***	0.0043***	0.0055***
	(3.85)	(3.03)	(2.29)	(3.43)	(4.43)	(3.99)	(3.74)	(4.88)
10 (high)	0.0127***	0.0072***	0.0048***	0.0067***	0.0133***	0.0077***	0.0052***	0.0075***
	(4.44)	(3.84)	(3.39)	(4.83)	(4.60)	(4.08)	(3.58)	(5.34)
High – low	0.0091***	0.0098***	0.0092***	0.0081***	0.0100***	0.0106***	0.0097***	0.0094***
	(4.11)	(4.42)	(4.09)	(3.54)	(4.75)	(5.04)	(4.58)	(4.35)

Panel B: Clone stock returns of portfolios classified by industry and policy uncertainty

	Equally weighted returns				Value weighted returns			
	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha	Excess returns	1-Factor alpha	3-Factor alpha	4-Factor alpha
1 (low)	0.0013	-0.0048***	-0.0068***	-0.0049***	0.0030	-0.0030	-0.0053***	-0.0032**
	(0.44)	(-2.57)	(-4.65)	(-3.40)	(0.99)	(-1.60)	(-3.78)	(-2.32)
2	0.0023	-0.0033**	-0.0054***	-0.0032***	0.0038	-0.0018	-0.0039***	-0.0018
	(0.83)	(-1.99)	(-4.25)	(-2.63)	(1.41)	(-1.08)	(-3.13)	(-1.47)
3	0.0042	-0.0013	-0.0033***	-0.0014	0.0055**	0.0001	-0.0023**	-0.0008
	(1.61)	(-0.88)	(-2.82)	(-1.25)	(2.11)	(0.07)	(-2.09)	(-0.73)
4	0.0062**	0.0010	-0.0015	-0.00005	0.0057**	0.0004	-0.0020*	-0.0003
	(2.47)	(0.67)	(-1.45)	(-0.05)	(2.23)	(0.24)	(-1.95)	(-0.33)
5	0.0069***	0.0015	-0.0009	0.0005	0.0067***	0.0014	-0.0006	0.0008
	(2.68)	(1.02)	(-0.93)	(0.49)	(2.69)	(1.03)	(-0.59)	(0.86)
6	0.0091***	0.0038***	0.0015	0.0025***	0.0093***	0.0041***	0.0021**	0.0028***
	(3.65)	(2.78)	(1.60)	(2.72)	(3.75)	(2.90)	(2.15)	(2.78)
7	0.0088***	0.0034**	0.0012	0.0021**	0.0094***	0.0040***	0.0015	0.0026***
	(3.47)	(2.44)	(1.21)	(2.26)	(3.72)	(2.92)	(1.63)	(2.73)
8	0.0105***	0.0053***	0.0029***	0.0039***	0.0117***	0.0065***	0.0046***	0.0053***
	(4.23)	(3.73)	(2.94)	(3.91)	(4.68)	(4.54)	(4.30)	(4.99)
9	0.0135***	0.0081***	0.0059***	0.0071***	0.0109***	0.0054***	0.0029***	0.0044***
	(5.15)	(5.21)	(5.09)	(6.14)	(4.21)	(3.80)	(2.79)	(4.33)
10 (high)	0.0138***	0.0082***	0.0069***	0.0075***	0.0121***	0.0064***	0.0049***	0.0058***
	(4.82)	(4.48)	(4.80)	(5.17)	(4.34)	(3.80)	(3.87)	(4.58)
High – low	0.0125***	0.0129***	0.0137***	0.0124***	0.0091***	0.0095***	0.0102***	0.0090***
	(6.06)	(6.22)	(6.50)	(5.83)	(5.16)	(5.38)	(5.70)	(4.96)

Appendix 1
Variable Definitions

Variables	Definitions
Geographic tie indexes	
CTI1	The first-level cabinet tie index. $CTI1_j = Level1_j$, where $Level1_j$ is an indicator of the home state of the President. Only the President (the most powerful member of the administration) is considered in this index.
CTI2	The second-level cabinet tie index. $CTI2_j = ½Level1_j + ½Level2_j$, where $Level2_j$ is the total number of level 2 cabinet members from state *j*. If a member's background split into more than one state, we assign a value to each state after dividing by the number of states. Level 2 includes the vice-President, the "big four" (Secretary of State, Secretary of Treasury, Secretary of Defense, and Attorney General), and the Chief of Staff.
CTI3	The third-level cabinet tie index. $CTI3_j = \frac{1}{3} Level1_j + \frac{1}{18} Level2_j + \frac{1}{33} Level3_j$, where $Level3_j$ is the total number of level 3 cabinet members from state *j*. If a member's background split into more than one state, we assign a value to each state after dividing by the number of states. Level 3 includes the other cabinet members (Secretary of Interior, Secretary of Agriculture, Secretary of Commerce, Secretary of Labor, Secretary of Health, Education and Welfare, Secretary of Housing and Urban Development, Secretary of Transportation, US Representative to UN, Chair Council of Economic Advisers, Director of Office of Management and Budget, and Office of Trade Representative).
PROX	The degree of firm's proximity to state capital, computed by the expected distance minus actual distance of firm to its state capital, i.e. the inverse value of residual value in the following regression equation. Higher values indicate closer proximity to state capital. In each year we regress the model using the data of previous years. $Distance_{i,y} = b_0 + \Sigma b\ State_{i,y} + \Sigma b\ Capital_{i,y} + \Sigma b\ Firm_{i,y} + \Sigma b\ Industry\ dummies + \varepsilon_{i,y}$, where *Distance to capital* is the statutory mile between the firm and the capital, which is measured by the latitudes and longitudes of the two points. We identify the latitude and longitude information from the US Census Bureau's Gazetteer Place and Zip Code Database. *State* variables include *State size* (in $miles^2$) and *State population*. *Capital* variables include *Capital's relative population*, *MSA*, and *Distance of capital from next large city*. *Firm* variables include *Percentage of same industry firms close to capital*, *Number of large cities around the firm*, and *Firm age* (after adding one and taking the log).
Policy risk	
PAI	The party alignment index, computed by $PAI_j = ¼S_j + ¼R_j + ¼G_j + ¼\ [½\ S_j^{state} + ½\ R_j^{state}]$, S_j = the fraction of the state's two senators in Washington that belong to the President's party. R_j = the percentage of the state's house representatives in Washington that belong to the President's party. G_j = a dummy variable equal to one if the governor belongs to the same party as the President, and zero otherwise. S_j^{state} = a dummy variable equal to one if the percent of members of the state senate belonging to the President's party is greater than 50%, and zero otherwise. R_j^{state} = a dummy variable equal to one if the percent of representatives in the state house belonging to the President's party is greater than 50%, and zero otherwise. The information on party affiliation and control is extracted from different volumes of "*Taylor's Encyclopedia of Government Officials: Federal and State*" and "*State Elective Officials and the Legislatures.*"
State variables	
Convictions	The Convictions, extracted from the US Department of Justice Public Integrity Section (http://www.usdoj.gov/criminal/pin/).
Dependence on government	The sum of all procurement contracts of the firms in the state (billion $). Information of procurement contracts is obtained from the Federal Procurement Data System – Next Generation (FPDS-NG).
Voter turnout at state level	The percentage of eligible voters who cast a ballot in the election, measured at the state level.
Close election at state level	A dummy for the election in which the winner's margin is less than 2%, measured at the state level.
State population	We compute the interpolated population estimates using the 1960, 1970, 1980, 1990, 2000, and 2010 US Census.
Relative capital population	The ratio of capital population to state population.

County variables	
Voter turnout at county level	The percentage of eligible voters who cast a ballot in the election, measured at the county level.
Close election at county level	A dummy for the election in which the winner's margin is less than 2%, measured at the county level.
County in capital	A dummy for county located in the capital city.
City variables	
Community politics	It is obtained from the DDB Life Style data to measure the degrees of community sociability. Following Brown, Ivković, Smith, and Weisbenner (2008), we use a survey question (#112, coded ADVICE) states "My friends and neighbors often come to me for advice about products and brands." The answers from respondents range from 1 to 6, i.e. 1 (definitely disagree), 2 (generally Disagree), 3 (moderately disagree), 4 (moderately agree), 5 (generally agree), and 6 (definitely agree). We transform the value by having the unit interval, i.e. from zero (definitely disagree) to one (definitely agree). In each year, we compute the average value for the MSA in which individuals reside by requiring at least 7 survey answers for one area. Community politics is the average score of the community area. In case we do not have any values for the community, we use the state-level average.
Firm characteristics	
Size	The market value of common equity. In the regressions, it is transformed by adding one and taking the natural log.
B/M	The ratio of market common equity to book common equity for the firm.
Beta	It is computed using weekly stock returns.
Past return (-1, -1)	One-month stock return in month -1.
Past return (-4, -2)	Three-month stock return from months -4 to -2.
Past return (-12, -1)	Twelve-month return from months -12 to -1.
Turnover	The average over the year of the monthly trading volume scaled by the number of outstanding shares.
Leverage	Total debt in current liabilities plus total long-term debt, divided by total assets.
R&D expenditures to sales	R&D expenditures adjusted by sales.
Advertising expenditures to sales	Advertising expenditures adjusted by sales.
ROA	Net income divided by total assets.
Dividend yield	Total dividends paid divided by price at the end of the previous year.
Firm age	The natural log of one plus the number of years since the stock inclusion in the CRSP database.
Litigation	A dummy that equals 1 if the lawsuit is filled a given calendar year y, and otherwise equals 0. The Stanford law school maintains the Securities Class Action Clearinghouse that has complied federal class actions related to a security fraud. We obtain litigation data from (http://securities.stanford.edu/fmi/xsl/SCACPUDB/recordlist.xsl).
Forecast revision	The percentage change in the median analyst forecast between m-1 and m. In case that forecast is missing for particular months, we use the last available median forecast value.
Industry dummies	The 11-industry classification modified based on the Fama-French 10-industry classification. The first (consumer non-durables) industry includes food, tobacco, textiles, apparel, leather, and toys. The second (consumer durables) industry includes cars, TV's, furniture, and household appliances. The third (manufacturing) industry includes machinery, trucks, planes, chemicals, and paper. The fourth (energy) industry includes oil, gas, and coal extraction and products. The fifth (high tech) industry includes computers, software, and electronic equipment. The sixth (telecommunication) industry includes telephone and television transmission. The seventh (shops) includes wholesale, retail, and some services such as laundries and repair shops. The eighth (health) industry includes healthcare, medical equipment, and drugs. The ninth (defense) industry includes guns, tanks, aircrafts, and ships for defense purpose. The tenth (construction) industry includes general and heavy constructions. The eleventh (other) industry includes mines, transportation, hotels, entertainment, and finance.

Appendix 2
State Rankings by Geographic Ties

This table documents the top ten states based on the level of geographic ties. We compute the average of geographic tie scores under each presidency and rank the state by the third-level geographic tie index (*CTI3*). Three levels of the Presidential cabinet are considered, in accordance with the power and influence of different administration members. Level 1 includes only the President (the most powerful member of the administration). Level 2 includes the vice-President, the "big four" (Secretary of State, Secretary of Treasury, Secretary of Defense, and Attorney General), and the Chief of Staff. Finally, Level 3 includes the other cabinet members (Secretary of Interior, Secretary of Agriculture, Secretary of Commerce, Secretary of Labor, Secretary of Health, Education and Welfare, Secretary of Housing and Urban Development, Secretary of Transportation, US Representative to UN, Chair Council of Economic Advisers, Director of Office of Management and Budget, and Office of Trade Representative). For each state j, $CTI3_j = (1/3)*Level1 + (1/18)*Level2 + (1/33)*Level3$, where *President* is an indicator of the home state of the President. *Level2* (*Level3*) is the total number of level 2 (level 3) cabinet members from state *j*. If a member's background split into more than one state, we assign a value to each state after dividing by the number of states.

Year President	1968 Johnson (D)	1969 – 1976 Nixon (R) / Ford (R)	1977 – 1980 Carter (D)	1981 – 1988 Reagan (R)	1989 – 1992 Bush (R)
1	Texas	California	Georgia	California	Texas
2	Maryland	New York	Minnesota	Texas	New York
3	Minnesota	Michigan	New York	New York	Indiana
4	New York	Maryland	Idaho	New Jersey	Wyoming
5	Illinois	Massachusetts	Texas	Tennessee	Illinois
6	Virginia	Ohio	Illinois	Massachusetts	California
7	Arizona	New Jersey	Louisiana	Pennsylvania	Pennsylvania
8	California	Illinois	Washington	Nebraska	New Hampshire
9	Florida	Wisconsin	Michigan	Illinois	New Jersey
10	New Jersey	Pennsylvania	New Jersey	Michigan	Georgia

Year	1993 – 2000	2001 – 2008	2009 – 2014	Whole sample period, 1968 – 2014	
President	Clinton (D)	Bush (R)	Obama (D)	State	Average *CTI3*
1	Arkansas	Texas	Illinois	California	0.1763
2	New York	Illinois	New York	Texas	0.1439
3	California	California	Delaware	New York	0.0904
4	Tennessee	Wyoming	California	Illinois	0.0841
5	Florida	Massachusetts	Kansas	Arkansas	0.0593
6	Arizona	New York	Iowa	Georgia	0.0410
7	Illinois	Florida	Texas	Michigan	0.0289
8	Texas	Missouri	Washington	Massachusetts	0.0243
9	Maine	Kentucky	Colorado	New Jersey	0.0212
10	Kansas	Maryland	Nebraska	Florida	0.0198

Appendix 3
Reverse Predictability

This table presents the results of panel vector autoregressions (panel VAR). At the beginning of every calendar month, all firms are classified into 125 sub-samples based on the quintiles of *size*, *B / M*, and *Past return (-12, -1)*, where *size* = the natural log of one plus market value of common equity, *B/M* = the ratio of book value equity to market value equity, and *Past return (-12, -1)* = twelve-month return from months -12 to -1. *CTI3* = the third-level cabinet tie index. *PROX* = the degree of firm's proximity to state capital. The first order panel VAR model is as follows:

$$NP_t = \beta_{11}P_{t-1} + \beta_{12}NP_{t-1} + e_t$$
$$P_t = \beta_{21}P_{t-1} + \beta_{22}NP_{t-1} + e_t$$

where *NP* = the monthly returns of the portfolios with lower geographic ties (i.e., no *CTI3* or lower *PROX*), while *P* = the monthly returns of the portfolios with higher geographic ties (i.e., none-zero *CTI3* or higher *PROX*). *P*-values are reported in brackets for the tests of the difference between the coefficients of the lagged variables in both *P* and *NP* regressions and the difference between the lagged *P* coefficient in the *NP* regression and the lagged *NP* coefficient in the *P* regression. Refer to Appendix 2 for detailed variable descriptions. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	CTI3-based analysis		*PROX*-based analysis	
	Dep. var. = NP_t	Dep. var. = P_t	Dep. var. = NP_t	Dep. var. = P_t
P_{t-1}	0.0902***	0.0748***	0.1075***	0.0872***
	(13.87)	(10.80)	(16.50)	(11.77)
NP_{t-1}	0.0696***	0.0877***	0.0551***	0.0764***
	(10.11)	(12.93)	(8.26)	(10.89)
Test: $\beta_{11} - \beta_{12}$	0.0206**		0.0523***	
[*p*-value]	[0.015]		[0.000]	
Test: β_{21} - β_{22}	-0.0129*		0.0107	
[*p*-value]	[0.091]		[0.147]	
Test: β_{11} - β_{22}	0.0025		0.0310***	
[*p*-value]	[0.394]		[0.001]	
N	61,739		62,019	