Lobbying Index Beats the Market

By
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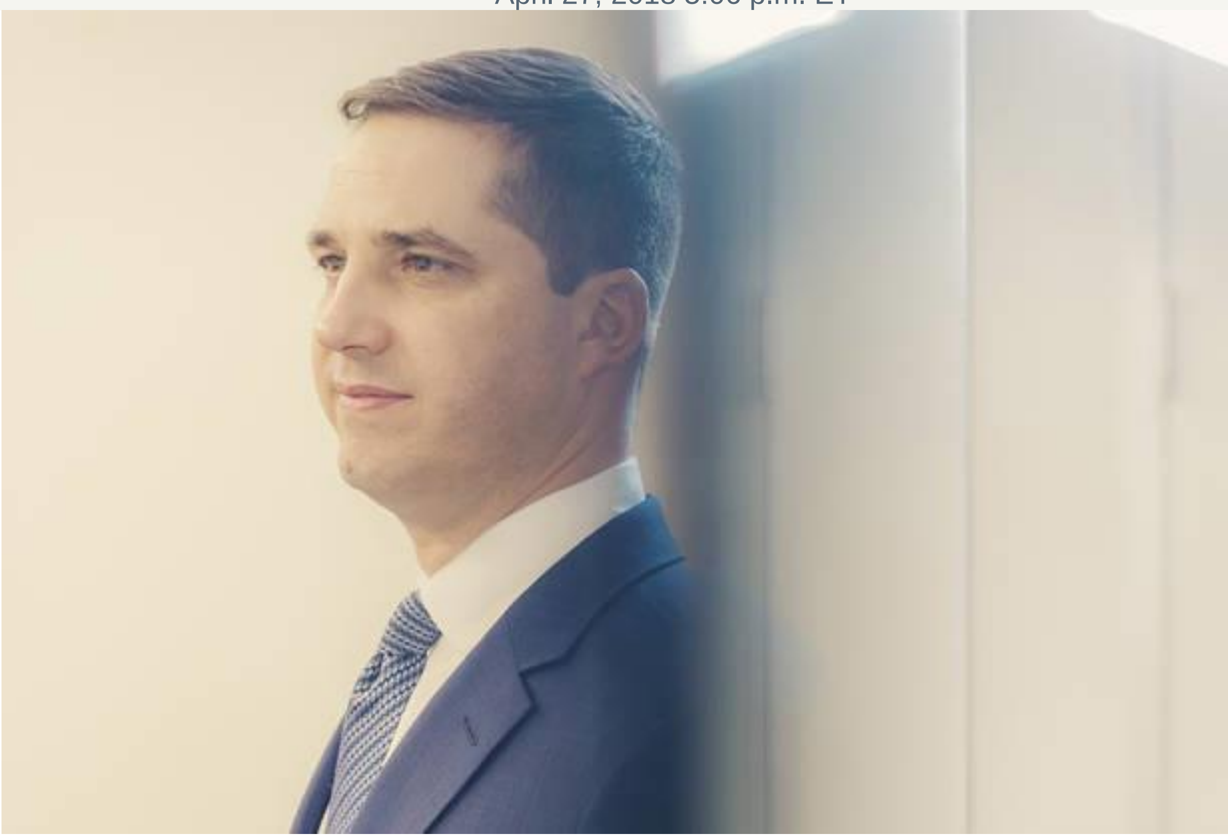


Daniel Clifton, head of policy research for Strategas Securities, says companies recognize their political risks and opportunities before investors do. *PHOTO: JARED SOARES*

Corporate lobbying of government is a critical component of business strategy in the U.S., and for good reason. Favorable regulations can help companies grow their markets, keep competitors at bay, and fatten the bottom line. If an investor could methodically capture the lobbying effect on earnings, something Wall Street doesn't seem to do well, that presumably could lead to better stock-market returns.

"Washington, D.C., is a factor not accounted for by investors, but should be because an increasing portion of earnings is decided in the capitol," says Daniel Clifton, the Washington-based head of policy research for Strategas Securities, a broker-dealer.

About 10 years ago, Strategas devised a "lobbying" index of companies that get the most bang for their lobbying buck, including interactions with regulators. The index, it says, has outperformed the Standard & Poor's 500 for nearly a decade by an average of almost five percentage points annually. The lobbying index returned an average 14.4% annually from its 2009 launch through April 13, versus 9.5% for the S&P 500. About $1 billion of assets are pegged to the performance of the Strategas index.

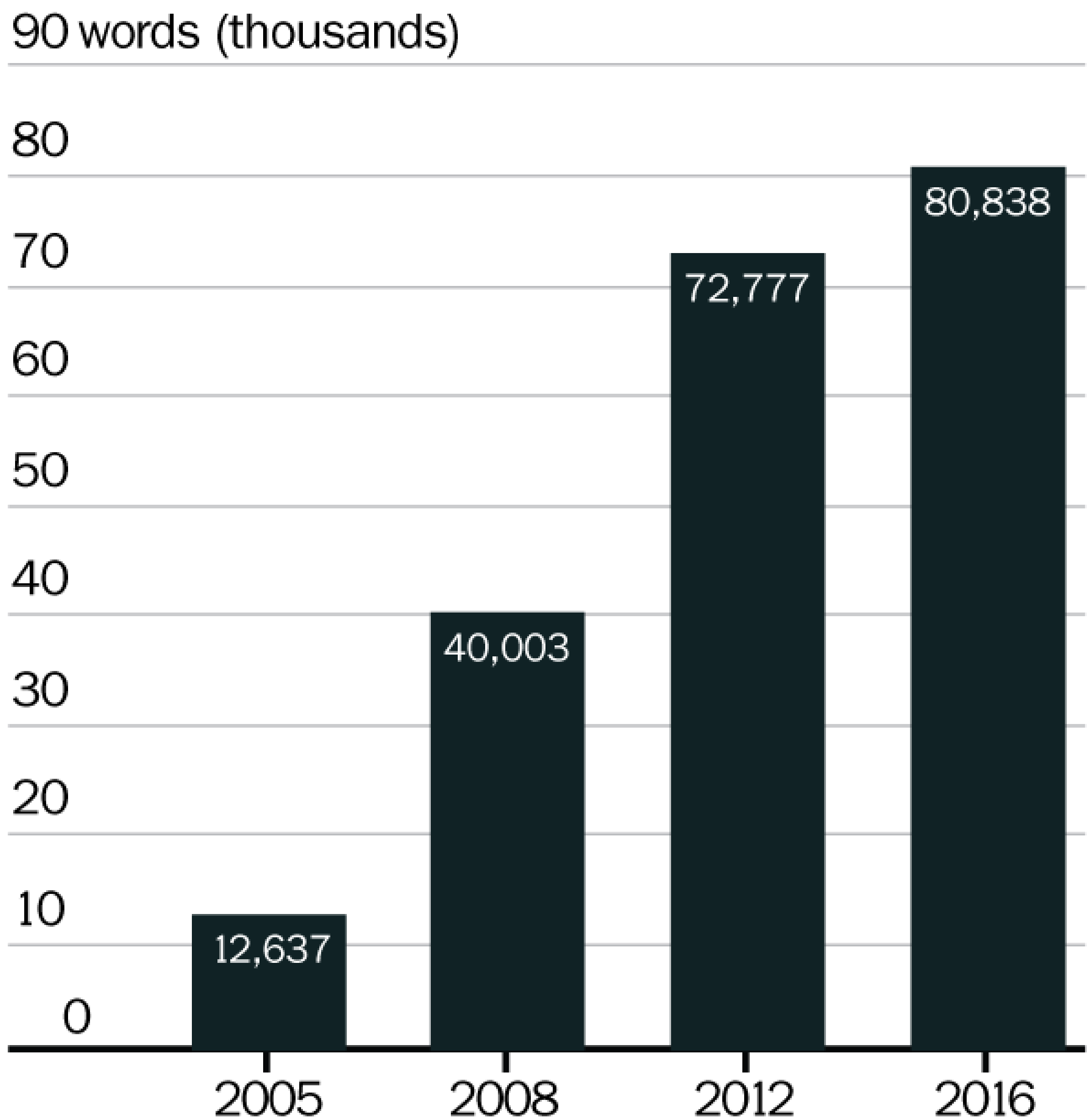
Since the financial crisis, U.S. companies increasingly have namedgovernment as a risk factor in Securities and Exchange Commission filings. According to Strategas, in a sample of companies representing 44% of the S&P 500, the total words dedicated to government risk in annual reports doubled to 80,000 in 2016 from 2008. "Companies recognize their D.C. risks and opportunities faster than investors do," Clifton says, noting they use lobbying to position themselves before shifts in public policy that might hurt revenue or challenge business models.

Yet the earnings benefit derived from successful lobbying often is mispriced by the market, he contends.

Finding these companies is at the heart of the lobbying index, which went live in February 2009. Institutional investors sought to invest in the strategy, and in 2014 the Strategas Public Opportunities Portfolio was born. It is run by Strategas Asset Management for separately managed accounts.

With Regulatory Risk Rising...

Since the financial crisis, more U.S. companies have cited government as a risk in SEC filings.



Source: Strategas Securities

Some $900 million is invested in the strategy by institutional clients that receive the list of 50 index components quarterly and implement the investments on their own, says Clifton, a former lobbyist and past executive director of the American Shareholders Association. Another $120 million or so is managed by Strategas. As of the end of March, the fund had returned 59.6%, after fees, since the first dollar went into the strategy in September 2014, compared with the S&P's total return of 42% over the same span, the firm says. The fund hasn't yet been evaluated by third parties, such as fund-rater Morningstar.

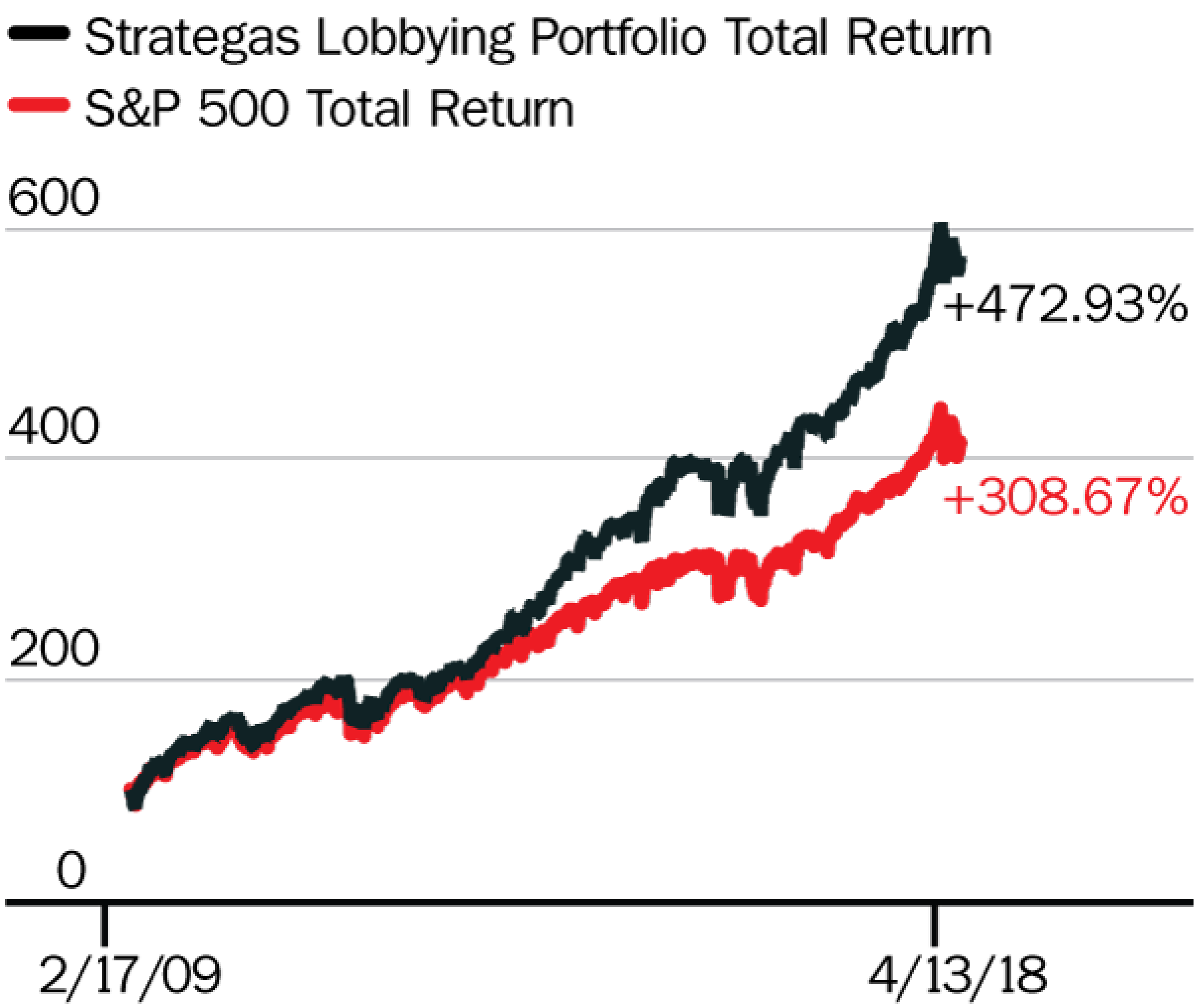
Clifton, who heads index construction and manages the portfolio, wouldn't share the specific parameters for inclusion in either, but said they reflect "the companies that are investing in Washington," and that selection is based on quantitative criteria. Strategas' screening also incorporates more traditional valuation metrics tied to balance-sheet measures, market capitalization, and earnings growth. Index components generally are mid- and large-caps companies.

Clifton says total lobbying outlays aren't the determining factor in index construction. "If that were the case, Alphabet [GOOGL], parent of Google, last year's biggest [lobbying spender] at $18 million, or another big spender like General Electric [GE], would be in the fund, but they aren't," he says. "Those kinds of companies have big staffs in Washington and are lobbying on pretty much everything."

The return on their "lobby dollar" is largely gauged by success in preventing harmful regulations and encouraging favorable ones with a specific earnings impact.

...Effective Lobbying Pays Off

The Strategas lobbying index of 50 companies that derive significant earnings benefits from lobbying activity has outperformed the stock market since its launch.



Source: Strategas Asset Management

Strategas accounts for the issue being lobbied, and how direct the relationship is to company earnings. The biotech industry, for instance, has a great record of lobbying as it fights drug-pricing restraints, the firm noted in a report late last year.

Mastercard (MA) has been in the index since February 2009. The Purchase, N.Y.–based company operates in an effective duopoly, competing with Visa (V). It is well-run, has a strong balance sheet, and has enjoyed spectacular stock-price gains. Mastercard "has shown itself ready to spend what it takes to protect its turf," whether on payment-processing issues, tax reform, or trade, Clifton says. Recently, it hired Michael Froman, a former U.S. trade representative in the Obama administration, as president of strategic growth, a move likely to yield a positive return from a lobbying perspective. Other stocks in the index include FedEx (FDX), Raytheon (RTN), and Vertex Pharmaceuticals(VRTX).

Strategas says the biggest criticism of the index from would-be clients is that the returns reflect sector bias. Clifton responds that index constituents typically outperform the sector to which they belong and that the sectors in the index typically outpace the market. Currently, of the 11 S&P 500 sectors, only telecom and utilities aren't represented in the index.

Strategas' focus on corporate lobbying has some support from a November 2016 working paper, "Accounting for Rising Corporate Profits: Intangibles or Regulatory Rents?", by James Bessen, executive director of the Technology and Policy Research Initiative at Boston University School of Law. Bessen, who isn't connected to the firm, found that investments in conventional assets, such as machinery and research and development together boosted valuations and profits during the 1990s. However, since 2000, political activity and regulation have accounted for a surprisingly large share of the increase in valuations and profits, he maintains.

Strategas clients seem to like the strategy. Amy Magnotta, head of discretionary portfolios at Brinker Capital, says the index and fund offer a competitive edge. "It's trying to exploit something that no one else is doing in the large-cap space, where it is very hard to differentiate oneself," she says.