Research Report

# Regional Political Climate and Individual Investors' Portfolios

THE LARGE FIELD OF PSYCHOLOGICAL AND NEUROSCIENTIFIC LITERATURE SUGGESTS THAT POLITICAL PREFERENCES STEM FROM OUR INDIVIDUAL CHARACTERISTICS AND PERSONAL VALUES AND ARE FORMED MUCH EARLIER THAN THE PERSON IS CONFRONTED WITH ANY KIND OF FINANCIAL DECISION. THIS ARTICLE INVESTIGATES WHETHER POLITICAL PREFERENCES AND POLITICAL CLIMATE CAN HAVE AN IMPACT ON FINANCIAL DECISIONS OF INDIVIDUAL INVESTORS – IN PARTICULAR, PORTFOLIO COMPOSITION AND PREFERENCES FOR NATIONAL SECURITIES.

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**Introduction**

It is well documented that there exists significant heterogeneity in the behavior of investors which cannot be explained by a set of observable demographic or economic factors. One source of this heterogeneity stems from the fact that individuals have different tastes for financial assets that are hard to observe but can play a significant role in shaping investors' expectations (Fama and French, 2007). At the same time, psychological research has shown personal values and personality traits are responsible for forming political preferences which are partly exogenous and stable throughout the life (Campbell et al., 1960).

Political climate is measured along the left-right (liberate-conservative) dimension. Party identification as left or right is seen as a kind of heuristics that eases the voters orientation in the political environment. Huber and Inglehart (1995) have shown that a single right-left factor helps communicate to the electorate the main focus of party opinions on different economic issues.

In this paper, I consider political preferences in order to account for the unobserved personal characteristics and link them to investment decisions of individuals (see Figure 1). This is an interesting and important link given that political climate has become an increasingly relevant topic in the recent years in Europe. The rising popularity of extreme parties and the Brexit are just a couple of examples of the political challenges that Europe is facing today. Understanding how households react to the changing political environment can be useful for a vast audience, including governments, banks, politicians, and financial advisors.

**Psychological Roots of Political Preferences and Their Impact on Financial Decisions**

This paper rests on three strands of literature: psychology, political science, and finance.

Psychological literature (e.g., Block and Block, 2006) suggests that certain personal characteristics that are already observable in early childhood are related to the political preferences of an adult. Neurocognitive science (Amodio et al., 2007) confirms the results that there are differences in perceiving information and coping with uncertainty between conservative and liberal individuals. These findings suggest that political values and preferences are partly exogenous and not only environment-related. In this paper, I look at political preferences of investors to extrapolate their expectations towards financial markets and shed light on the determinants of their portfolio decisions.

Personal characteristics and values are fundamental for one's behavior and have an impact on the life choices of individuals, including investments. These characteristics form one of the main sources of investor heterogeneity but are, unfortunately, difficult to measure directly. They may lead to such investment decisions as preference for national securities (home bias), socially-responsible investing (avoidance of "bad" companies, such as tobacco or alcohol), or overweighting employer's stocks. Despite some evidence that the impact of psychological factors diminished with investor sophistication, there is enough literature to suggest that even agents such as mutual fund managers are prone to biases caused by personal traits.

Political preferences have been used as one

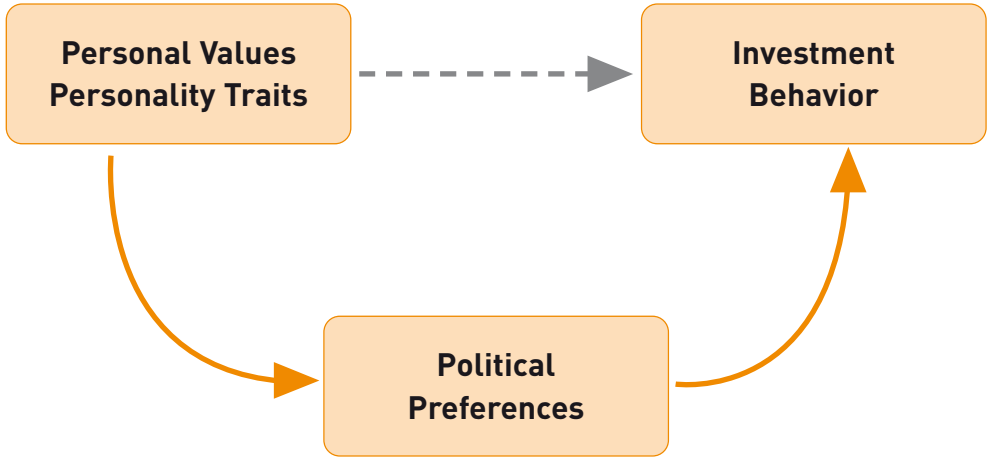


Figure 1: Impact of Political Preferences on Financial Decisions

of the proxies for investors' preferences in recent research. Most of the interest has been assigned to the topic of political preferences of large market players (fund managers and analysts). Hong and Kostovetsky (2012) and DeVault and Sias (2017) elaborate on the differences in the behavior of fund managers and analysts based on their affiliation towards the Republican or Democratic Party in the US. However, the evidence on the portfolio composition of individuals is still scarce. Kaustia and Torstila (2011) show that right-wing voters are more likely to invest in stocks by inferring people's political identities from the regional political climate.

Bonaparte et al. (2017) examine whether political climate together with political identity as a measure of optimism can help infer individuals' expectations about the economy.

**Empirical Investigation**

Given that personal values are related to political preferences, on the one hand, and to financial decisions, on the other hand, I expect political preferences and investment behavior to be related. I use political orientation as a channel through which individuals express their personal values and reveal personality traits. Taken together, these political values of a group of individuals form the political climate at the regional level, which can be either left- or right-wing dominated.

The differences in political climate across Germany and associated investment variables on a bank level are investigated here. Since the interest of this analysis lies in the regional differences, I restrict the whole universe of banks to those which operate on a regional basis (cooperative and savings). They play a significant role in the German financial system. Slightly more than 80% of all the domestic households' deposits are held at such banks (50% at savings and 30% at credit cooperatives). Thus, one can assume that individuals use their regional banks as the main provider of financial services. Figure 2 gives an overview of individual investors' portfolios at regional banks. On average, portfolio characteristics at regional banks are close to the averages across Germany, which supports the idea that the selected sample is representative and suits well the purposes of the research.

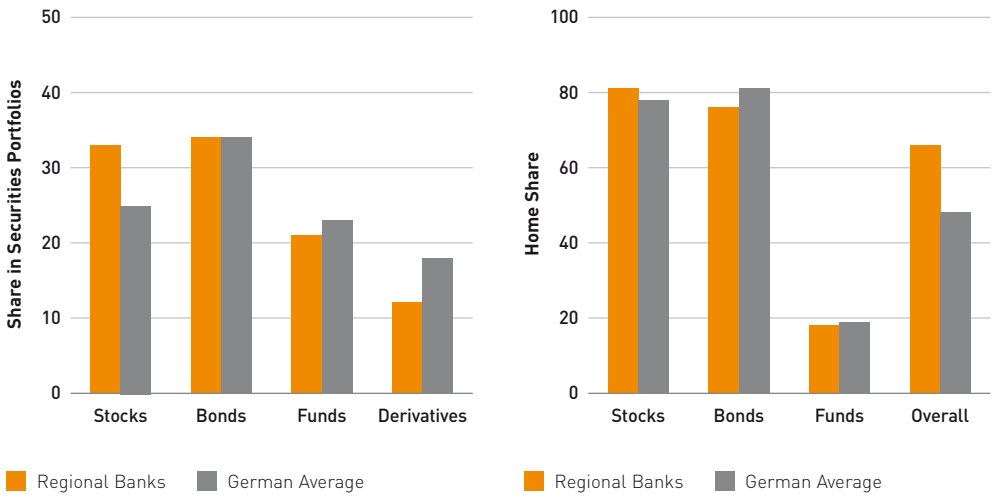


**Figure 2: Investors' Portfolios at Regional Banks**

The data on political climate comes from two sources: election results and the survey evaluating people's attitude towards political parties. It allows to quantitatively evaluate political climate at a district level and to use it as the main descriptive variable ("political score") in statistical tests. Figure 3 depicts the average political score across Germany with darker color corresponding to left-wing dominated regions.

The Free Democratic Party (FDP) and the Christian Democratic (Social) Union of Germany (CDU/CSU) promote economic liberalism, free markets, and private ownership. On a left-right scale, they have higher-than-average scores (center-right). Their supporters are expected to share the same beliefs about financial markets. Left-wing parties (Die Linke) are known for their antipathy towards financial markets. Therefore, their supporters are less likely to participate in the financial market. However, this attitude is not driven by risk aversion.

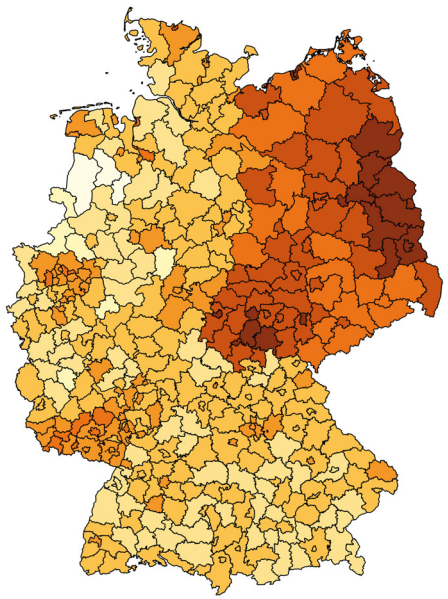

**Figure 3: Average Political Score across German Regions**

On the contrary, the psychological literature suggests that right-wing ideology supporters are more likely to be risk averse. Therefore, the first hypothesis reads:

H1: In the districts where political climate is more right-oriented, investors are more likely to participate in financial markets and invest more in securities portfolios relative to deposits.

However, the conservatism dimension on top of that works in the other direction: psychological literature provides evidence that two main conservatism traits are resistance to change and justification of inequality, which are related

to such characteristics as death anxiety, threat of system instability, dogmatism, fear of loss. Openness to experience, uncertainty tolerance, integrative complexity are common for liberal individuals. For this reason:

H2: Within securities portfolios, in the right-wing dominated regions individuals allocate larger part of their wealth to safer product classes.

Finally, politically optimistic people are expected to have higher expectations of the local market. Political optimism is defined as condition when the ruling party coincides with one's preferred ideology. Given the fact that the German Parliament is dominated by right-wing parties since 2005, the third hypothesis is:

H3: In the districts where majority of voters support right-wing parties, investors are likely to be more optimistic about the economy and, thus, to exhibit higher levels of home bias.

### Discussion of the Results

A more right-wing political environment has a positive influence on the participation rate at the district level. An increase of one in political score (which translates to the movement from average left to average right) increases the participation on a district level by around 0.7 percentage points, which is a significant increase of more than 10% given that the average participation rate equals to 7%. Moreover, individuals in right-wing dominated districts hold higher share of their wealth in securities relative to deposits. This confirms the hypothesis that right-wing climate transmits the liberal attitudes towards financial markets to the individual investors which forces them to invest relatively more in securities.

Conditional on participation, households in right-wing tilted districts are less likely to invest in riskier products such as derivatives, and more likely to hold safe assets (bonds and funds). The impact on stocks share is negative, although statistically insignificant. An increase of one in political climate in the right direction causes a decrease of 8% in derivatives holdings and an increase of approximately 3% in bond and fund shares. These results are partially in line with conservatism of right-wing supporters. For example, structured products are riskier, imply more uncertainty, and form a relatively new class, and, therefore, do not fit the psychological characteristics of (politically) conservative individuals.

Other potential explanations such as differences in investment culture between East and West Germany, differences in personal characteristics of the party supporters (FDP supporters are considered to be wealthier), or the impact of social capital are ruled out here. In order to account for these issues, I include a wide set of control variables, including fixed effects for states, regional unemployment and average income, as well as two common proxies of social capital (home ownership and voter activity). Although most of these controls are statistically and economically significant, the coefficient of political score remains significant as well.

Although there is some effect of political climate on home shares, it is rather marginal. This suggests that the political climate can have an impact on the overall attitude towards financial markets, however, it does not help overcome or explain such investment mistakes as high levels of home bias. This measure is, thus, linked to such personal characteristics as attitudes towards risk, conservatism, or liberalism, but does not relate to financial sophistication or literacy, which are usually known to be responsible for the investment mistakes. The results also suggest that election surprise and (or) political uncertainty can influence home bias. However, discussion of these issues is out of the scope of this paper, but could become a valid point for future research.

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