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Red versus Blue: Do Political Dimensions Influence the Investment Preferences of State Pension Funds?

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Abstract
Studying the equity holdings of 31 U.S. state pension funds, we find evidence that the political leaning of their members and political pressures by state politicians impact funds' investment decisions. State pension funds from states with Democratic leaning members tend to tilt their portfolios more strongly towards companies that perform well on environmental, social and governance (ESG) issues, as compared to their Republican counterparts. This tendency is especially strong if the majority of the state government are Democrats. State pension funds intensify their ESG investing when their members' political leaning changes from Republican to Democratic, and vice versa, suggesting that these funds align their ESG investment approach with the political leaning of their members. Finally, we find that the state pension funds in our sample neither under- nor outperform on their politically-motivated ESG holdings, implying that their ESG preferences are unlikely financially-driven.

Keywords
ESG, political pressures, political values, portfolio decisions, state pension funds, SRI

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1 Introduction

With assets over USD 3.3 trillion at the end of 2013 and an average ownership share of 7-8% of the total U.S. equity market over the last decades,[1] U.S. state pension funds are a major market force in the U.S. and global financial markets (Tonello & Rabimov, 2010). Their market power is highly concentrated in the largest state pension plans, providing these funds with enormous influence through their holdings of equity positions in large publicly traded companies.[2] Additionally, the future pension payments of a considerable share of American workers rely on the investment decisions of these funds.[3] As a result, the investment choices of U.S. state pension plans are of high relevance for the financial markets as a whole and for the future wealth of the state's population. However, little is known about the determinants of these investment choices, as compared to mutual funds and hedge funds, the other two major institutional investor classes (Brown, Pollet & Weisbenner, 2015).

One of the most prominent trends in state pension funds' investment activities in the latest years is their growing interest in incorporating environmental, social and governance (ESG) criteria into their investment decisions, e.g. by considering issues of environmental protection, sustainability and good corporate citizenship (e.g. Johnson & Greening, 1999; Di Guili & Kostovetsky, 2014). For example, nine state and local government plans are signatories of the United Nations supported Principles for Responsible Investment (PRI) and thus committed to incorporate ESG issues into investment practices across asset classes.[4] Moreover, several U.S. state pension funds actively pursue investment strategies that promote an ESG related agenda; the most prominent example being CalPERS. The largest among the state pension funds is known for its "long standing commitment to sustainable investment and a proud history of leadership and innovation in the field".[5] However, relatively little is known about the determinants of state

[1] See http://www.census.gov/newsroom/press-releases/2015/cb15-22.html.

[2] According to the 2013 Public Fund Survey, USD 2.74 trillion are centred in the 100 largest funds, thus comprising approximately 85 percent of the entire state and local retirement system. See http://www.publicfundsurvey.org/publicfundsurvey/summaryoffindings.html.

[3] As of 2013 more than 28.8 million Americans participated in state and local pension plans (see http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk). Even taxpayers that are not employed in the public sector have a stake in how these pension plans are managed because the responsibility for funding these defined benefit plans lies with the sponsoring government.

[4] These pension funds comprise CalPERS, CalSTRS, Connecticut Retirement Plans and Trust Funds (CRPTF), Illinois State Board of Investments, Los Angeles County Employees Retirement Association (LACERA), Maryland State Retirement and Pension System, New York City Employees' Retirement System, New York State Common Retirement System, State Universities' Retirement System of Illinois. All of these pension funds are located in states that are predominantly Democratic leaning, as classified by their overall votes in the presidential election from 1996 to 2012. Several of these pension funds are also founding and drafting members of the PRI and thus they are at the forefront of the socially responsible investment (SRI) movement.

[5] See for example the CalPERS' 2014 Report "Towards Sustainable Investment & Operations" in which the fund describes its ESG initiatives including an environmental investment initiative, a carbon asset risk

pension funds' ESG investing. Most empirical research regards U.S. state pension funds as one homogeneous group with respect to their preferences towards ESG and corporate governance (e.g. Johnson & Greening, 1999; Woidtke, 2002; Cremers & Nair, 2005; Di Guili & Kostovetsky, 2014). This is surprising as anecdotal evidence suggests that only individual funds have acquired the reputation as activist and "responsible" investors.

One natural link to ESG investing that has not been investigated by the previous literature on state pension funds is the political leaning of those investing. According to the 2007 National Consumer League survey, 95% of Democrats are of the opinion that the U.S. Congress should ensure that corporations help social issues, whereas only 65% of Republicans regard this as an important matter. A 2014 survey by Gallup on Americans' views on a variety of societal issues finds that 23% of Democrats worry about 'race relationships', compared to 12% of Republicans, 53% of Democrats regard 'hunger and homelessness' as a pressing issue compared to only 33% of Republicans, 'climate change' is a major worry for 36% of Democrats (10% of Republicans) and 45% of Democrats care strongly about the 'quality of the environment' (16% Republicans).[6] These differences in preferences make ESG investing an optimal background for studying the influence of political values on ESG investing. Assuming that the attitudes towards ESG issues enter the decision-making process of investors, Democratic leaning investors should have a stronger preference for ESG related investments than Republicans. And, indeed, there is a growing literature showing that political values are a major determinant of investors' preferences for ESG. For instance, Hong & Kostovetsky (2012) study individual mutual fund and hedge fund managers' portfolio choices and provide empirical evidence that Democratic leaning managers favour stocks with a higher ESG rating than Republicans. Bonaparte, Kumar & Page (2012) confirm the preference for ESG investing for the case of Democratic leaning private investors. However, many individuals do not actively invest in the stock market but a major share of their wealth is bound in their pension claims and invested via their occupational pension schemes. The question whether political influences also impact the investments of the state and local pension plans that invest the assets of these beneficiaries has not been addressed in the previous literature.

In this study our aim is to close this gap in the literature. In particular, we demonstrate that the political climate of the state, alongside other well-known stock characteristics, significantly impacts the funds' preferences for ESG investing. We differentiate between political beliefs of the

initiative, its initiatives promoting diversity and inclusion policies as well as its sustainable investment research initiative (http://www.calpers.ca.gov/eip-docs/about/pubs/esg-report-2014.pdf). CalSTRS' sustainable investment practices comprise, among others, a green initiative task force, a carbon disclosure project as well as several initiatives promoting diversity (http://www.calstrs.com/sustainable-investment-practices).

[6] Among the major worries of Republican leaning respondents are federal spending and the budget deficit, the size and power of the federal government and the state of the overall economy.

funds' members and the political agenda of the state politicians. Looking at the detailed equity holdings of 31 U.S. state pension funds, we find that funds with Democratic leaning members tilt more strongly towards companies with high ESG performance than their Republican counterparts. Additionally, political pressures on state pension funds as proxied by the proportion of Democrats in the state government also impact a fund's tendency to engage in ESG investing. When combining these two effects, we find support that funds with a Democratic leaning membership base show a stronger ESG preference when the state government is predominantly affiliated to the Democratic Party. In contrast, funds from states with Republican leaning members do not seem to engage in ESG investing, even if the state government is predominantly composed of Democrats. We interpret these results as indicative that state pension funds incorporate their members' political values and attitudes towards ESG issues into their investment choices. In line with this interpretation, we find evidence that funds dynamically adjust their ESG investment approach around changes in their members' political leaning. Finally, we focus on the performance effect of the politically motivated ESG investing. While we find that state pension funds, on average, seem to underperform on their active investment choices this underperformance does not seem to be connected to their ESG investing. In fact, we find that the state pension funds in our sample neither out- nor underperform on their politically-motivated ESG holdings, suggesting that their ESG preferences are unlikely financially-motivated but mainly attitude-driven. Our main results remain robust to numerous alternative explanations and variations, including different ways of defining the political proxies, variations of measuring companies' ESG performance, as well as industry effects and effects of indexing.

Our study makes several contributions. To the best of our knowledge, we are the first to show that fund members' preferences have a significant impact on state pension funds' investment allocations. Whereas the previous literature predominantly focuses on political corruption and pressures to explain some of the investment practices by pension funds (e.g. Brown et al., 2015; Wald & Zhang, 2015; Hochberg & Rauh, 2013; Mohan & Zhang, 2014; Bradley, Pantzalis & Yuan, 2015), we find that political pressures merely have a moderating effect in explaining funds' ESG investing.[7] Our paper also extends the growing literature on political values in finance. While there is substantial research on the impact of politics on financial markets, independent corporations and (individual) investors, to the best of our knowledge we are the first to document that political values also impact ESG investments at an institution-based level and not only on a single manager basis. Finally, our paper has important implications for the investment

[7]In particular, Brown et al. (2015) find that it is the amount of campaign contributions received by a governor from a particular county that determine the state pension fund's likelihood to hold stocks from this county, whereas measures of voting outcomes from gubernatorial elections seem to have no significant effect on in-state pension holdings.

decision process in state pension funds and the debate about funds' fiduciary duty in the context of ESG investing. While we do not find support that politically-motivated ESG investing weakens financial performance and thus potentially violates their fiduciary duty, our results suggest that these funds generally underperform on their active investments, i.e. investments that they over- or underweight relative to market weights.

The rest of the paper is organised as follows. The next section provides an overview of the underlying literature. Section 3 and 4 describe the data and methodology, respectively. In Section 5, we discuss the results of our main analyses. Section 6 provides an analysis of the performance effects of the politically motivated ESG investment. We consider several alternative explanations and robustness tests in Section 7 and conclude in Section 8.

2 Literature Review

2.1 ESG Investing in State Public Pension Funds

State and local pension plans are among the most active investors promoting change in the corporate governance as well as other areas of corporate policies of the companies they are invested in (e.g. Smith, 1996; Del Guercio & Hawkins, 1999; Gillian & Starks, 2000; Parrino, Sias & Starks, 2003; Barber, 2007). One of the earliest studies providing empirical evidence that U.S. state pension funds favour companies that perform well on ESG issues is by Johnson & Greening (1999). It shows that U.S. state pension funds hold a larger ownership share in companies with stronger ESG performance. In comparison, the authors do not find a similar relationship for a control group of investment management funds. A recent study by Di Guili & Kostovetsky (2014) confirms that the percentage of ownership by U.S. state pension funds is positively related to the ESG performance of the underlying company. However, both studies focus on the corporate perspective by looking at the percentage of outstanding shares held by state pension funds instead of directly employing funds' portfolio holdings. Holdings tend to be more indicative of funds' investment preferences, though, as argued in Fich, Harford & Tran (2015), because they directly reflect funds' portfolio allocation decisions.[8]

Despite the broad anecdotal and academic evidence documenting ESG activities by U.S. state pension funds, there is relatively less research on the heterogeneity in state pension funds' ESG

[8] In fact, the portfolio weight that a fund holds in a specific company (i.e. the pension fund perspective) and the percentage of outstanding shares held by the fund with respect to the total number of the company's outstanding shares (i.e. the company perspective) might not even be strongly related. For instance, in our sample the correlation between both variables only amounts to only 2.7 %.

investing.[9] In most empirical studies, U.S. state pension funds are regarded as one homogeneous group with respect to their preferences towards ESG and corporate governance (e.g. Johnson & Greening, 1999; Woidtke, 2002; Cremers & Nair, 2005; Di Guili & Kostovetsky, 2014). Notable exceptions are the studies by Cox, Barmmer & Millington (2007), Sievaenen, Rita & Scholtens (2013) and Sandberg, Juravle, Hedesstroem & Hamilton (2009) that analyse differences in ESG investment practices across pension funds. These studies find that the level of competition (Cox et al., 2007), the legal origin, public ownership of the fund, the fund size (Sievaenen et al., 2013) as well as cultural differences between regions and countries (Sandberg et al., 2009) can explain part of the heterogeneity of pension funds' ESG investing. However the aforementioned studies either focus on a different market and external management such as Cox et al. (2007) or draw comparisons between different (European) countries (Sandberg et al., 2009; Sievaenen et al., 2013) and thus do not capture the differences between U.S state pension funds' ESG investing. More importantly, none of these studies connects the pension funds' ESG activities to political factors.

2.2 Influence of Politics in State Public Pension Funds

Some of the earliest research shedding light on the influence of politics in state pension funds is undertaken by Romano (1993, 1995). In her studies, the author provides anecdotal evidence of political pressures on funds to base their voting policies on political considerations, such as increasing in-state employment and engaging in so-called economically-targeted investments (ETI).[10] Romano (1993, 1995) shows that the fund's return on investment is negatively related to the degree of political influence in its organisational form.[11] A study by Woidtke (2002) finds a more general value destroying effect of state pension fund investments. Her findings suggest that companies in which state pension funds hold a large ownership share tend to decrease in firm value, while there is no similar value-destroying effect for corporate pension fund investments. According to Woidtke (2002), these results relate to the weaker governance structures in state pension funds inducing managers to follow their own personal agenda, including social and political motivations. Coronado, Engen & Knight (2003) analyse whether political inferences in

[9] In this paper we use the term ESG investing to capture investments that are, among other factors, based on non-financial factors such as environmental, social and governance criteria. This also comprises investment practices that are known as responsible investing (RI) and socially responsible investing (SRI) by investment professionals and academia.

[10] ETIs are intended to boost the state's economy, often jeopardising financial returns.

[11] These results are in line with findings by Nofsinger (1998) that show that ETIs have a negative performance effect on funds. However, more recent studies including Munnell & Sunden (2001) and Hess (2005) do not find support for a significant impact of ETIs on fund returns. Mohan & Zhang (2014) argue, though, that these results may not be representative of the overall public pension fund landscape as they are based on a small sample of funds and do not account for the recent shift in legislation that allows further pension funds to make ETIs.

public pension funds can explain the lower return of this investor class as compared to private funds.[12] Contrary to previous findings, they conclude that political influences do not strongly impact funds' performance.

Recently, several studies have revisited the issue of political pressure on state pension funds' investments (e.g. Wald & Zhang, 2015; Harper, 2008; Novy-Marx & Rauh, 2011; Andonov et al., 2014). These studies suggest that the level of a state's political corruption is related to state pension funds' asset allocation, performance, funding status, and expenses. However, political pressures not only affect funds' investment decisions on the asset allocation level but also impact their security selection (Hochberg & Rauh, 2013; Brown et al., 2015; Bradley et al., 2015). Brown et al. (2015) look at local biases in pension funds' public equity allocations and find that the 20 state pension funds in their sample strongly overweight in-state stocks. Regarding the motivations for this local bias, the authors provide evidence that, among other factors, the overweighting is positively linked to the share of political campaign contributions received by a county. Hochberg & Rauh (2013) find a similar local overweighting for private equity investments of state pension funds. They document that this overweighting is especially strong for states with higher levels of self-dealing by politicians. Finally, Bradley et al. (2015) most directly relate funds' in-state investment bias to political connections. They show that state pension funds strongly overweight local firms that make political contributions to local (state) politicians or that have significant lobbying expenditures and they find that this political bias is detrimental to fund performance. Additionally, their results suggest that the political bias is positively related to the proportion of politically affiliated trustees on pension funds' boards and their congressional connections.

While the previous literature solely focuses on political connections and political corruption when analysing the impact of politics in state public pension funds, an emerging stream of the literature investigates whether political values and norms play a role in financial decision making. Previous research on political values in finance has focused on corporate policies (e.g. Hutton, Jiang & Kumar, 2014; Di Guili & Kostovetsky, 2014) and investment decisions by both individual and institutional investors (Kaustia & Torstila, 2011; Bonaparte et al., 2012, Hong & Kostovetsky, 2012). For instance, Hutton et al. (2014) analyse the influence of personal political preferences of corporate managers on corporate financial policies and find that Republican managers tend to adopt more conservative corporate policies. Kaustia & Torstila (2011) concentrate on the stock market participation of individual investors in Finland and show that the political orientation of

[12]Their study focuses on three potential channels of political influence in state public pension plans: (1) requirements for investing a certain proportion of assets within the state, (2) restrictions on investing in certain countries or industries, and (3) the methods through which trustees are chosen to serve on the board of trustees.

Finish individual investors influences their likelihood to invest in the stock market, with left-wing voters being less likely to participate. Also focusing on individual investors, Bonaparte et al. (2012) find that investors are more optimistic and increase the allocation to risky assets when the political climate is aligned with their own political affiliations, i.e. Democratic investors invest more in relatively riskier stocks when the Democratic Party is in power than when the Republicans are the dominant political force.

Two studies co-authored by Kostovetsky link the tendency to incorporate ESG criteria in financial decision making to the political leaning of corporate managers as well as mutual fund and hedge fund managers. In particular, Di Guili & Kostovetsky (2014) find that firms with Democratic leaning CEOs, founders and directors spend more on ESG activities and have a higher ESG rating than companies with no affiliations to the Democratic Party. In comparison, Hong & Kostovetsky (2012) analyse the portfolio holdings of individual Democratic leaning mutual fund and hedge fund managers, as proxied by their contribution to presidential candidate election campaigns. The authors find that Democratic leaning fund managers underweight industries that are not in line with the Democratic political agenda such as tobacco, guns & defence, and natural resources.[13] Additionally, Democratic managers are more likely to invest in environmentally friendly firms and firms that score well on other issues connected to the Democratic political agenda, such as diversity, community and employee relations. The authors argue that corporate managers and investors might derive utility from the ESG activities that are in line with their political values, as in both studies the ESG related spending or investments do not translate into direct financial benefits.

On the backdrop of these findings, our aim is to investigate how political influences impact state pension funds' tendency to incorporate ESG criteria into their investment decisions. First we ask whether state pension funds' preferences for ESG investing are related to the political leaning of their members and/or political pressures by state politicians. We then analyse the effect of both political influences in combination in order to assess whether one has a moderating effect on the other. Moreover, we are interested in the dynamics of the impact of political influences on pension funds' ESG investing both with respect to changes in the members' political leaning as well as the general public attitude towards ESG investing. Finally, we look at the performance effects of the politically-motivated ESG.

[13]Bonaparte et al. (2012) make a similar observation for Democratic leaning investors using political affiliations identified based on the geographical location of the investors, i.e. whether they are from counties with strong Democratic or Republican leaning.

3 Data

3.1 Data Sources and Sample Construction

The backbone of this study are two databases: (a) the Thomson Ownership Holdings Database of institutional investor equity holdings, and (b) the company ratings for environmental, social and governance criteria by Kinder, Lydenberg, Domini, & Co., now MSCI (MSCI KLD). Additionally, we rely on the CRSP database for stock price data and the Compustat database for financial data to control for company-specific characteristics. We obtain data on state pension fund characteristics from the public plans database provided by the Centre for Retirement Research at Boston College (CRR) which we supplement with manually collected data from the Comprehensive Annual Financial Reports (CAFR) of the state pension funds in our sample. In order to construct the political proxies for testing the hypotheses, we rely on a variety of data sources that are described in Appendix A along with all other variables.

1) State pension funds' Holdings Data

We obtain data on the public equity holdings of U.S. state pension funds from the Thomson Ownership Database. The Thomson Ownership Database mainly relies on the holdings reported to the Security Exchange Commission (SEC) but further supplements this information with holdings data gathered from international filings as well as shareholder reports. In the U.S., all institutional investment managers who exercise investment discretion over USD 100 million and whose holdings are not externally managed must report their holdings with the SEC.[14] This restricts our sample to large state pension funds with internally managed holdings. Since we are interested in pension-fund specific factors and their effect on funds' investment decisions it is crucial that we only look at internally managed holdings to rule out that our results are affected by investment processes and incentive effects of external managers.[15]

In order to define the sample of state pension funds, we manually searched the Thomson Ownership database and identified 31 state pension funds which are located in 23 states.[16]

[14]The externally managed holdings are filed under the name of the external management company. The only exceptions for internally managed portfolios from filing their holdings with the SEC are for small holdings (below 10,000 stocks and USD 200,000 invested) or in special circumstances in which the SEC grants a confidentiality waiver.

[15]This data structure is especially important as the external manager might be headquartered in a different state than the pension plan, his or her investment decisions might be affected by the fund's internal incentive structures or by his or her own political opinions, as shown in Hong & Kostovetsky (2012).

[16]There are at least two potential reasons why our sample covers a relatively small number of plans from the total U.S. public pension fund universe. First, some of the smaller public pension funds might not meet the threshold of reporting and are thus exempt from disclosing their holdings. Second, several funds might choose to outsource their portfolio management to external managers, as pointed out in Del Guercio & Tkac (2002) and Lakonishok, Shleifer & Vishny (1992).

Compared to previous studies that rely on U.S. state pension fund equity holdings, our sample is comparable in size and even larger than the sample of plans usually employed in the literature (e.g. Woidtke, 2002; Cremers & Nair, 2005; Dittmar & Mahrt-Smith, 2007; Brown et al., 2015; Bradley et al., 2015). Table 1 lists the names of the 31 pension funds in our sample and their respective state. It also provides further summary statistics at the pension-fund level. For each of the 31 state pension funds, we obtain observations on their public equity holdings for a sample period running from 1997Q1 to 2013Q4. We do not have holdings data for all 31 funds over the entire sample period as some funds only report their holdings for sub-periods of the sample. The average (median) number of quarters per fund is 43 (55). For 14 of the 31 funds, we are able to obtain holdings data over the entire sample period. The average number of funds per quarter is 19, with a minimum of 15 pension funds per quarter for 1997Q1 and a maximum of 26 pension funds per quarter for 2013Q4. In order to test whether our sample of state pension funds is representative of the average U.S. state pension fund, we compare our sample to all funds included in the public plans database of the CRR. In order to preserve space, results of this analysis are presented in Appendix B. We find that, besides differences in fund size, our 31 funds show features comparable to the 126 plans in the CRR database.

As we aim to explain the allocation of a fund's portfolio to ESG companies, our main variable of interest is the company's weight in the fund's portfolio. We call this variable portfolio weight (w_{ijt}). Following Grinblatt, Titman & Wermers (1995)[17], we calculate portfolio weights (w_{ijt}) in the following way:

$$w_{ijt} = \frac{val_{ijt}}{\sum_i^N val_{ijt}} \ ,$$

where val_{ijt} is the value of company *i* held by pension fund *j* at the end of a quarter *t* and $\sum_i^N val_{ijt}$ is the total portfolio value held by pension fund *j* at the end of quarter *t*. In the majority of our analyses, we restrict our sample to S&P500 companies and set the portfolio value held in a specific S&P500 company (val_{ijt}) in relation to the fund's total holdings in S&P500 companies so that $\sum_i^N val_{ijt}$ does not capture the fund's entire holdings. This is due to data restrictions for the ESG measures, as we will explain in the next section. In robustness tests we confirm that our main results remain robust to an extended company coverage.

[17]For a further study that employs a portfolio weight measure similar to ours see Badrinath & Wahal (2002).

2) Environmental, Social and Governance Ratings

We obtain ratings of a company's ESG performance from Kinder, Lydenberg, Domini, & Co., now MSCI, which are the most commonly used ESG ratings in the literature.[18] MSCI KLD assesses companies on seven ESG-specific categories on a point-by-point basis. These categories comprise: community activities, diversity, employees' relations, environmental record, product quality, human rights, and corporate governance. In order to arrive at a rating for each category, MSCI KLD scans various data sources, such as public databases, media reports, corporate advertising and surveys, which are then assessed by a team of analysts that assign a point for each strength and each concern (e.g. Kotchen & Moon, 2012; Hong & Liskovich, 2014). For instance, the community activities category comprises seven different strength items (i.e. charitable giving, innovative giving, non-U.S. charitable giving, support for housing, support for education, volunteer programs, and other strengths) and four concern items (i.e. investment controversies, negative economic impact, tax disputes, and other concerns). In case a company has a charitable giving program in place MSCI KLD assigns it one point for community strength, whereas the presence of a tax dispute would lead to one community concern point. Aggregating the points within a particular category, we calculate a score of strengths and a score of concerns for each of the seven categories. We then deduct a company's total concerns ($KLD\ Concerns_{it}$) from its total strengths score ($KLD\ Strengths_{it}$) to arrive at a single KLD score for every company, the *KLD Net score*:

$$KLD\ Net\ Score_{it} = KLD\ Strengths_{it} - KLD\ Concerns_{it}\ .$$

Netting the strength and concern scores is a common approach in empirical finance studies to derive a single indicator for a company's ESG performance (e.g. Hong & Kostovetsky, 2012; Di Guili & Kostovetsky, 2014; Hong & Liskovich, 2014).

In the early part of the sample period, KLD only issued ratings for S&P500 companies and companies that were a member of the Domini 400 Social Index. In the early 2000s, KLD expanded its company coverage several times, such that it now covers the Russell 3000 universe

[18]Despite being widely used in empirical finance research, the MSCI KLD data source is not without its critics. In fact, MSCI itself now suggests to use a more recent one of their ESG measures to access companies' ESG performance. The reason why we still rely on the standard MSCI KLD scores are twofold: Firstly, it has a long history of available ratings for a considerable share of the U.S. equity market which is not available for comparable ESG measures. Secondly, it has been employed in the previous studies that investigate the impact of political factors on ESG investing and thus makes our results more comparable to the existing literature. A detailed discussion on the advantages and disadvantages of using the KLD rating as a measure for the ESG performance of a company can be found in Chatterji, Levine & Toffel (2009), Cheng, Hong & Shue (2013) and Hong, Kubik & Scheinkman (2012). Despite concerns of using KLD scores, several studies indicate that the equal-weighted KLD score does indeed capture the past environmental performance, predict future environmental performance (Chatterji, Levine & Toffel, 2009) as well as philanthropic donations (Cheng, Hong & Shue, 2013), and is correlated with the "values" of investors and managers (Hong & Kostovesky, 2011; Bonaparte et al., 2012; DiGiuli & Kostovetsky, 2014).

(Kotchen & Moon, 2012). In order to avoid any time bias in our findings, we focus our analysis on the S&P500 holdings of the state pension funds, which is a standard approach in the literature (e.g. Hong & Kostovetsky, 2012). However, in later robustness tests we check whether the results are sensitive to the inclusion of the extended company coverage. Figure 1 compares the total aggregated value of the funds' equity holdings in all companies (solid line) with their holdings in S&P500 companies only (dotted line) as well as their holdings in all companies with KLD ratings (dotted line). As can be seen, holdings in S&P500 companies constitute a major share of the total funds' holdings. They represent, on average, more than 75% of the funds' portfolio value. This is consistent with findings in Brown et al. (2015) documenting that state pension funds overweight S&P500 companies and large companies in general relative to market weights. MSCI KLD updates its ratings at the end of each year and publishes the ratings in January. In order to avoid any look-ahead bias we use the rating that applies to the previous year to evaluate a company's current ESG performance.

Table 2 provides summary statistics on the KLD scores for the S&P500 companies. The mean *KLD Net score* across companies is 0.43. Looking at the seven KLD subcategories we find that their mean values also lie closely around zero but that there is some variation between the different categories. Turning to the range of the average *KLD Net scores* we can evaluate the degree of company-specific distance in scores. With a minimum value of -11 and a maximum of 19, the *KLD Net score* seems to vary to some degree across companies, though the range for the KLD subcategories is far lower.

In the last column of Table 1, we report portfolio weighted KLD Net scores per fund, in which the weight is based on the dollar value of the firm's holding in the fund. To generate the scores we first calculate portfolio weighted KLD Net scores per quarter and average these across time. Based on the values in Table 1 there seems to be some variation in average portfolio-weighted *KLD Net scores* across pension funds, with a cross-sectional average weighted *KLD Net score* of 1.11. We note that pension funds with fewer quarters of data tend to have a higher average *KLD Net score*. This might indicate trends in the levels of KLD scores, a pattern that we will control for in later robustness tests.

3) Proxies for the Political Leaning and Political Pressures

Next we turn to the proxies for the political leaning of the funds' members as well as political pressures on funds. Barber (2007) argues that if pension funds are to incorporate ESG criteria into their investment decisions, they should align their choices with the moral values and political interests of their investors rather than their own. As state pension funds most likely do not have detailed information on the political affiliations of their members, the closest proxy for

the political interests of their members is the political leaning of the state they are located in. We judge this as a viable proxy for the members' political values as members of state pension funds represent a considerable share of the state's population and state pension funds indirectly account responsible to all taxpayers of a state.[19] Note that we do not require that all members of a state pension fund located in states concentrated by Democrats (Republicans) be Democrat (Republican). Rather, we only assume that investors in states concentrated by Democrats (Republicans) are more likely to subscribe to the Democratic (Republican) political ideologies.[20] To capture whether a state's population is Democratic leaning, we construct a dummy variable (*Democrat-Dummy*) that takes the value of one if the percentage of a state's votes received by the Democratic Party according to the latest presidential election results is larger than the percentage of the state's votes received by the Republican Party, and zero otherwise. We obtain the data on presidential election results per state from Dave Leip's Atlas of U.S. Presidential Elections for the elections from 1996 to 2012.[21] This source is widely used in empirical studies in finance to proxy for the political environment of a state (e.g. Pe'er & Gottschalg, 2011; Di Guili & Kostovetsky, 2014). To check whether the states included in our sample show a comparable voting pattern to the average U.S. state, we compare the distribution of presidential votes for our 31 sample states to those of all U.S. states. The results of this comparison are presented in Figure 2. Panel A shows the election results by election year for all U.S. states. Panel B focuses on the states that are part of our pension fund sample during the particular election period. The proportions of votes received by the Democratic Party and the Republican Party only differ slightly between the two samples. Thus, we conclude that there are no major biases regarding the party affiliations for the pension funds in our sample.

Our proxy for political pressures by state politicians towards ESG investing is based on the composition of the state government. We follow Di Guili & Kostovetksy (2014) and define the proportion of a state's government that is affiliated to the Democratic Party (*% of Dem. State Gov*) as $\%\ of\ Dem.\ State\ Gov. = 0.5 * \text{Dem. Governor} + 02.5 * \text{Dem. Upper Chamber} + 0.25 * \text{Dem. Lower Chamber}$, where *Dem. Governor* is a dummy variable equal to one if the state governor is a Democrat, and zero otherwise, and *Dem. Lower Chamber* and *Dem. Upper Chamber* are the proportions of the Lower and Upper Chamber of the state government, respectively, that are affiliated to the Democratic Party. We then construct a dummy variable (*Dem. State Gov.-Dummy*) that captures whether the majority of the state government are Democrats. *Dem. State*

[19] As the responsibility for funding the defined benefit funds of the state and local pension plans ultimately lies with the sponsoring government, even taxpayers that are not employed in the public sector have a stake in how these pension funds are managed (e.g. Coronado et al., 2003; Brown et al., 2015).

[20] Recent studies have used a similar location-based identification strategy for individual investors to infer their political leaning (Bonaparte et al., 2012) as well as other investor characteristics such as education-level, religiosity and race/ethnicity (e.g. Hilary & Hui, 2009; Kumar, 2009; Korniotis & Kumar, 2011).

[21] See www.uselectionatlas.org.

Gov.-Dummy equals one if the state government is predominantly affiliated to the Democratic Party, i.e. if *% of Democratic State Government* is greater than 50%, and zero otherwise. The data on the composition of the Lower and Upper Chamber are taken from the U.S. Census Bureau's National Data Book: Gubernational and State Legislative. Information on State Governors is obtained from the National Governors' Association.[22]

4) Control Variables

Since portfolio allocation decisions can depend on a variety of company- and fund-specific factors, we employ a number of company-level as well as fund and state controls.

Company Controls

As a standard measure of firm size we use the *natural logarithm of the stock's market capitalisation*, which is measured as the product of the price per share and the number of shares outstanding (see also Feirrera & Matos, 2008; Hong & Kostovetsky, 2012; Di Guili & Kostovetsky, 2014; Brown et al., 2015). Firm size serves as a proxy for information asymmetries, with larger companies expected to show lower information asymmetries as they are more visible and subject to intense media scrutiny (Strike, Gao & Bansal, 2006). The *book-to-market ratio* provides a measure of a firm's expected growth opportunities and may indicate whether funds prefer companies for which market prices reflect substantial growth potential or whether they favour "value" stocks. We compute the book-to-market ratio as the natural logarithm of the book value of the firm's equity over the market value of equity, measured at the end of the previous quarter (see also Feirrera & Matos, 2008; Hong & Kostovetsky, 2012; Di Guili & Kostovetsky, 2014). The market value of the equity is updated every quarter, while the book value is based on the last fiscal year ending. The *dividend yield* is defined as the ratio of dividends per share over the price per share. It is measured at the end of the previous quarter and serves as a proxy for a company's dividend policy (see also Feirrera & Matos, 2008; Di Guili & Kostovetsky, 2014). Some investors might have policies in place that restrict them from investing in non-dividend paying firms or firms with large dividend cuts, as argued in Parrino, Sias & Starks (2003). Thus, controlling for these effects is important when analysing the portfolio allocations of institutional investors such as state pension funds. The *debt ratio*, defined as the ratio of the company's total debt over total assets, serves as a measure of firm distress and indebtedness (see also Cox, Brammer & Millington, 2004, 2007; Feirrera & Matos, 2008; Di Guili & Kostovetsky, 2014). We use lagged debt ratios, based on the last fiscal year ending. *Return on assets* is defined as the income before extraordinary items divided by total assets (e.g. Cox et al., 2004, 2007; Feirrera & Matos, 2008; Di Guili & Kostovetsky, 2014). It measures a company's accounting performance and thus might enter the set of factors

[22]See http://www.nga.org/cms/home.html.

based on which state pension funds make their portfolio allocations. In case that some of the state pension funds are momentum traders and condition their current portfolio allocations on past performance, we include a *stock's continuously compounded previous-quarter return* as an additional control. Finally, we include the *stock market beta* of a company to proxy for its exposure to the overall stock market risk (see Cox et al., 2007). We construct beta coefficients based on rolling regressions of a stock's monthly excess return on the market risk premium (i.e. the return on the S&P500 index in excess of the risk-free rate) and an intercept, over a 36 months window. We obtain the stock market beta for a particular month as the beta coefficient on the market risk premium estimated over a window ending at the previous quarter. For example, a company's beta for 1997Q1 is the beta coefficient estimated over 1994Q1-1996Q4.

Pension Fund and State Controls

We include the natural logarithm of the fund's actuarial assets under GASB standards to control for *fund size*. It is important to control for fund size for several reasons. Firstly, it can be assumed that the larger the fund, the more professional its asset management process and the more resources are allocated to investment research, including more investment staff and wider access to (ESG) databases. Secondly, as larger funds are more likely to hold a larger ownership stake in a company they could be considered as more influential shareholders and might get access to superior information, e.g. privileged meetings with the CEO. Thirdly, Coronado et al. (2003) provide evidence of a positive relation between the size of a fund's pool of assets and the incentive for political intervention as politicians seek to maximise their relatively short-term political interests.[23] Finally Sievaenen et al. (2013) show that larger funds are more likely to engage in ESG investing. Pension fund's security selection decisions might differ depending on the *proportion of their assets invested in equities*. For example, Coronado et al. (2003) show that the fraction of the portfolio invested in equities affects state pension funds' total rate of return. Thus, we expect that those funds that show a higher equity allocation and whose overall performance depends more strongly on the performance of their equity holdings, dedicate more resources to analysing and managing these holdings. The percentage of a pension fund's assets invested in public equities is supposed to control for these effects. Additionally, several recent studies show that the funding situation of a pension fund significantly impacts its portfolio allocation and risk-taking behaviour as well as the degree of political pressures on the fund (e.g. Novy-Marx & Rauh, 2011; Andonov et al., 2014; Mohan & Zhang, 2014). We control for the impact of a fund's funding status with the pension fund's *funded ratio* under the GASB standards, i.e. the ratio of actuarial assets over actuarial liabilities, updated at the end of the year (similar to

[23] Coronado et al. (2003) find a positive relation between fund size and the likelihood that funds engage in ETI programmes, state or country restrictions on investment, and the portion of elected members on the board of trustees.

Hochberg & Rauh, 2013). In addition, we employ the *proportion of shares outstanding held by a pension fund* in a particular company. It is defined as the ratio of the number of shares held by the pension fund over a company's total number of shares outstanding.[24] As pointed out in Parrino, Sias & Starks (2003) and Fich et al. (2015), the larger the ownership share of a fund in a company the more likely this fund is to have access to board members, senior managers, suppliers and customers of the company and thus to gain superior information. Moreover, the larger the fund's ownership shares the more attention and resources is the fund expected to allocate to that particular company. We also control for a state's level of *political corruption* which is defined as the number of federal, state and local public officials convicted of a corruption related crime, divided by the state's population.[25] This is a widely used measure in the finance and economics literature (e.g. Fisman & Gatti, 2002; Frederiksson, List & Millimet, 2003; Glaeser & Saks, 2006; Butler, Fauver & Mortal, 2009) and several previous studies have established that it is related to U.S. state pension funds' investment and funding decisions (e.g Hochberg & Rauh, 2013; Wald & Zhang, 2015; Bradley et al., 2015).[26] Similarly to Bradley et al. (2015)[27], we employ the *proportion of government employees who are union members* as a state-level control to capture the influence of unions in state pension fund decision making and investment processes. We retrieve the data from Barry Hirsch's Union Membership and Coverage Database which is described in Hirsch & Macpherson (2003).

Market Control

As a final control, we include the *return on the S&P500 index over the previous quarter*. It is supposed to capture time and market specific effects. To compute the variable, we take the natural logarithm of the monthly return on the S&P500 composite index after adding a value of one and we accumulate these monthly log returns over the previous quarter.

[24] As this variable might be (conceptually) closely related to our dependent variable, the portfolio weight measure, and thus might have a strong overlap with the dependent variable in terms of its information content, we calculated the correlation between the portfolio weights and the percentage of shares outstanding held by a pension fund in a particular company. As the correlation coefficient only amounts to 2.7 % we consider it unproblematic to include this variable in the regression models outlined in the next section.

[25] In unreported results we substitute the state population by the number of government employees to control for a potentially larger size of the government and thus larger number of public officials and government employees in Democratic-leaning states. Dividing the number of corruption convictions by the number of state employees and using this as the corruption proxy for a state, we find that our results are basically unchanged.

[26] For a discussion of the advantages and disadvantages of this measure of corruption see Glaeser & Saks (2006).

[27] Whereas Bradley et al. (2015) use the percentage of non-agricultural employees who are union members (which also includes private sector employees), we employ the number of public employees who are union members which we evaluate as a more direct measure of the for the influence of unions in public pension funds.

3.2 Summary Statistics

Table 3 provides summary statistics (Panel A) and a correlation matrix (Panel B) for the main variables described above. The average (median) portfolio weight held by a pension fund in one of the S&P500 companies is 0.23% (0.09%). The difference between the mean and median values relates to few pension funds allocating a large proportion of their portfolio to single companies.[28] Regarding the political leaning of the funds' members, the state population of the sample funds votes, on average, 50% for the Democratic Party, though the range of values from 25% to 63% indicates some strongly Democratic voting and some strongly Republican voting states in our sample. The mean value of 0.64 for the *Democrat-Dummy* implies that the members of the average pension fund are likely to be predominantly Democratic leaning. Additionally, we find that the pension funds in our sample tend to be from states with a Non-Democratic state government, as indicated by the mean values of the variables *% of Dem. State Gov.* (0.42) and *Dem. State Gov.-Dummy* (0.32) which clearly lie below 50%. This provides first evidence that the political leaning of the state population and the dominant party in the state government are not necessarily in line. Looking at the correlations between these political proxies we find further support for this conjecture (Table D.5, Appendix D). The correlation between the percentage of votes to the Democratic Candidate by the state population in presidential elections and the proportion of Democrats in the state government is only 36%. Turning to the correlations between our control variables, we find that the largest (absolute) correlations are no higher than 32% (Panel B of Table 3). Thus, we conclude that concerns of multicollinearity are not a major issue in our data.

Next we test whether there are systematic differences between pension funds with Democratic and Republican leaning members as well as between funds from states with a predominantly Democratic and Non-Democratic state government. We recalculate the mean values of the major variables and their standard deviations for these subgroups. Results are presented in Table 4. We find that there are no apparent differences between the subgroups regarding the average portfolio weights in a company. The same holds with respect to their preferences regarding certain company characteristics (except for KLD scores which we will focus on in the next section). This is to be expected as we restrict our analysis to S&P500 companies and do not condition on portfolio weights. Turning to the pension fund and state characteristics, funds with a Democratic state government tend to be slightly larger than their Non-Democratic counterparts, whereas funds with Republican members and from states with a Non-Democratic state government tend to have a higher portfolio allocation to equities. Interestingly, funding

[28] In unreported results we test that our main findings remain robust to excluding these funds with extreme portfolio allocations as well as funds with very few quarters of holdings data.

levels for funds from states with a Democratic and Non-Democratic state government seem to differ as the former show a weaker funding level than the latter. Furthermore, we find that funds from states with a Democratic leaning population appear to have a lower number of corruption convictions per capita than those with a Republican leaning population. In contrast, there is no apparent difference in the state's degree of political corruption based on the composition of the state government. Finally, there appears to be a difference between funds with Democratic and Republican members regarding union membership. In states with a Democratic-leaning population the union coverage among public employees is sizably higher than in those with a Republican population. This divide is less pronounced for funds from states with Democratic and Non-Democratic state governments. This provides support that our proxy for members' political leaning captures the attitudes and beliefs of the population, whereas the composition of the state government captures the characteristics of the political system.

3.3 Residual Portfolio-Weighted KLD Scores

To allow a first assessment of funds' ESG preferences, we next compare the portfolio-weighted KLD scores for subgroups of the pension funds, sorted by their members' political leaning and the composition of the state government. In particular, in each quarter we sort pension funds into groups with Democratic and Republican leaning members, as well as groups with a Democratic and Non-Democratic state government. We then calculate the average portfolio-weighted KLD scores for each of these subgroups. However, some company characteristics are related to the ESG performance of the company, most notably the size of a company and its book-to-market ratio. This might bias our results. For example, if a pension fund followed a size or value related investment style and these style characteristics were systematically related to KLD scores then it might appear that we are capturing ESG preferences while we truly measure style preferences. Following Hong & Kostovetsky (2012), we adjust the portfolio-weighted KLD scores for these style effects by running (quarterly) cross-sectional regressions of the portfolio-weighted KLD score of fund *j*'s holdings ($p.f.-weighted\ mean\ KLD_{jt}$) on the average portfolio-weighted log market capitalisation ($Mean\ Log\ Market\ Cap._{jt}$) and the average portfolio-weighted log book-to-market value ($Mean\ BM_{jt}$) of fund *j*'s portfolio at the end of quarter *t*, i.e.:

$$p.f.-weighted\ mean\ KLD_{jt} = \beta_0 + \beta_1 Mean\ Log\ Market\ Cap._{jt} + \beta_2 Mean\ BM_{jt} + \epsilon_{jt}\ . \quad (1)$$

We then assign each observation the residual from regression (1), i.e. ϵ_{jt}, which we call residual portfolio-weighted KLD score. Table 5 shows the average residual portfolio-weighted KLD scores by political subgroups. We find a clear distinction between funds with Democratic and Republican leaning members regarding their ESG preferences. If a pension fund has

predominantly Democratic leaning members its portfolio tends to exhibit a positive residual KLD score, while the residual KLD score for funds with Republican leaning members is negative for all but the employee relations category. We also report test statistics of a *t*-test on the mean residual scores for the two subgroups. The mostly positive and statistically significant differences between the KLD scores for the Democratic and Republican leaning sample provide preliminary evidence that funds with Democratic leaning members engage more strongly in ESG investing than their Republican counterparts. Only for the product quality category do we find a negative but statistically insignificant relation. In comparison, portfolios of pension funds from states with a Democratic state government tend to exhibit lower residual KLD scores than portfolios from funds whose state is governed by a Non-Democratic government in seven out of eight specifications.[29] This result is the opposite of what we would expect. We expected a positive difference as Democratic state politicians would exercise pressure on the state pension funds to increase their allocations to ESG investing. Thus, based on this preliminary analysis, it appears that the leaning of the funds' members determines their ESG investment approach.

4 Methodology

To ensure that the differences in ESG investing in the univariate analysis do not simply reflect differences in the institutional attributes of funds with Republican and Democratic leaning members or different preferences for company characteristics not captured by the style effects, we next examine the impact of the political factors on pension funds' ESG investment in a multivariate panel setting. We estimate a series of fixed effect panel regressions with the portfolio weight (w_{ijt}) as the dependent variable.[30] The main independent variables in the regression are the company's KLD score (KLD_{it-1}) and the KLD score interacted with one of the political proxies ($KLD_{it-1} \times political\ proxy_{jt}$). We scale the KLD score to an overall minimum of zero to facilitate the interpretation of the coefficient on the interaction term. We also include the set of control variables. Employing fixed effects at the *fund×security* level, the regression model can be expressed as follows:

[29]The difference is positive (but statistically insignificant) for the diversity subcategory.

[30]In order to select between the fixed effects and random effects estimator, we conduct the Hausman (1978) test. Its null hypothesis states that the error terms are not correlated with the independent variables, implying that the random effects estimator is the more efficient alternative (Greene, 2012). We find that for our model set-up, the null hypothesis is strongly rejected, suggesting that the fixed effects estimator is favoured over the random effects model. Thus, we estimate the above equation using a fixed effects estimator with fixed effects at the *fund×security* level and standard errors clustered at the *fund×security* level.

$$w_{ijt} = \beta_0 + \beta_1 KLD_{it-1} + \beta_2 KLD_{it-1} \times political\ proxy_{jt} + \beta_3' company\ controls_{it}$$

$$+ \beta_4' fund\ controls_{jt} + \beta_5 market\ control_t + v_{ij} + u_{ijt} \quad , \qquad (2)$$

where KLD_{it-1} is the KLD Net score scaled to a minimum of zero[31]; $political\ proxy_{jt}$ is either (a) the *Democrat-Dummy* or (b) the *Dem. State Gov.-Dummy*; $company\ controls_{it}$ and $fund\ controls_{jt}$ are column vectors of the seven company-specific and six fund-specific control variables described in Section 3.1 and listed in Appendix A; $market\ control_t$ is the quarterly S&P500 return; β_0. is the constant term; β_1, β_2, and β_5 are coefficient estimates on the respective variables; β_3' and β_4' are row vectors of the coefficient estimates attached to the variables contained in the $company\ controls_{it}$ and $\text{fund controls}_{jt}$ column vectors, respectively; v_{ij} are *fund×security* fixed effects and u_{ijt} is an idiosyncratic disturbance term.

The unit of measurement in model (2) is the *fund×security×quarter* level. As we employ a fixed effects panel model we only focus on the within-variation. That means we study the variation in portfolio weights per *fund×security* combination over time but not across funds and securities. Effects that are particular to the *fund×security* combination are captured in the fixed effects terms (v_{ij}). Since pension funds are expected to hold similar portfolio weights in a particular S&P500 company over consecutive quarters, we are doubtful that the error terms are independent across observations. To reflect this clustered sampling, we correct standard errors by clustering standard errors at the *fund×security* level.

Overall, we have slightly more than 550,000 observations with more than 20,000 *fund×security* effects. However, as some pension fund characteristics are not available over the entire sample period, including them considerably reduces the sample size to around 480,000 observations comprising about 18,000 *fund×security* effects. We run our baseline regressions on the reduced dataset with all controls; however, in unreported results we ensure that our main results remain robust to excluding variables with limited data availability.

5 Discussion of Results

5.1 Political Leaning, Political Pressures and their Combined Effect

Table 6 reports results from the fixed effects regressions (equation (2)). For all three model specifications presented in Table 6, we obtain negative and statistically significant regression coefficients on the KLD Net variable. This indicates that the unconditional relationship between a

[31] We scale the KLD scores to have an overall minimum of zero across all observations in order to use it in the interaction terms as negative values might complicate the interpretation of the coefficient on the interaction term.

pension fund's portfolio weight and a company's KLD score is negative. That is, the higher the company's ESG rating the less weight does this company generally have in a fund's portfolio (if we do not condition on the fund's political background). This finding might seem counterintuitive at first, since pervious research shows that state pension funds tilt towards ESG companies (e.g. Di Guili & Kostovetsky, 2014). One possible explanation may relate to funds' tendency to follow index weights (see Parrino et al., 2003). In unreported results, we find that there is a negative relation between a company's weight in the S&P500 index and its KLD rating.[32] If state pension funds followed S&P500 index weights, we would find a negative coefficient on the standalone KLD Net score (as we do). However, in this case the identified negative relation might not reflect funds' preferences towards ESG but rather their tendency to follow the S&P500 index. We control for this tendency in robustness tests.

In this study we are less interested in the unconditional relationship between portfolio weights and KLD scores, though, but we ask whether this relationship changes based on the fund's political background. To assess this question, the main variable of interest is the interaction term between the KLD score and the political proxies, i.e. the *Democrat-Dummy* or the *Dem. State Gov.-Dummy*. In specification (1), we employ the *Democrat-Dummy* to indicate whether the members of the pension fund are predominantly Democratic leaning. We find a positive and highly significant regression coefficient of 0.00213 on the interaction term of the *Democrat-Dummy* and the *KLD Net score*. Thus, while for the average fund the (unconditional) relationship between portfolio weights and ESG performance is negative, this relation becomes positive when conditioning on the (Democratic) political leaning of funds' members. From an economic perspective, this finding provides evidence that funds with Democratic leaning members engage more in ESG investing than their Republican counterparts.

In specification (2), we test whether conditioning on political pressures by state politicians impacts the fund's tendency to invest in companies with a higher ESG performance. To do so, we substitute the *Democrat-Dummy* with the *Dem. State Gov.-Dummy*. We find that there is a positive relation between the portfolio weight and the company's KLD score for funds from states where the majority of the state government is affiliated to the Democratic Party. Thus, in contrast to the preliminary analysis, the results of the fixed effect panel regression provide evidence that funds tilt more strongly towards ESG companies if the Democratic Party is the dominant force in the state government. However, when comparing the magnitude of the coefficient on the interaction terms with the *Dem. State Gov.-Dummy* and the one with the *Democrat-Dummy*, the

[32] In unreported regression results of the company's weight in the S&P 500 index on its KLD score along with the company controls we find a negative relationship between index weight and KLD score. This effect is mainly driven by the negative ESG exposure of the Oil & Gas industry and Utilities sector, as we will elaborate on in Section 7.1. See also Table D.2 in Appendix D.

effect of political pressures by Democratic state politicians seems to be considerably lower in economic magnitude.

This leads to the question which of these two effects is the major determinant of state pension funds' ESG preferences and which might merely have a moderating effect. In specification (3) of Table 6, we attempt to answer this question by conditioning on both the political leaning of funds' members and political pressures from state politicians. We construct four new dummy variables: *Democrat&Demstategov-Dummy* equals 1 if the funds' members are Democratic leaning and the majority of the state government are Democrats (i.e. *Democrat=1 & Dem. State Gov.=1*), and 0 otherwise; *Democrat&NonDemstategov-Dummy* takes the value of 1 if the funds' members are Democratic leaning and the majority of the state government is not affiliated to the Democratic Party (i.e. *Democrat=1 & Dem. State Gov.=0*), and 0 otherwise; *Republican&Demstategov-Dummy* equals 1 if the funds' members are Republican leaning and the majority of the state government are Democrats (i.e. *Democrat=0 & Dem. State Gov.=1*), and 0 otherwise; and *Republican&NonDemstategov-Dummy* takes the value of 1 if the funds' members are Republican and the majority of the state government is not affiliated to the Democratic Party (i.e. *Democrat=0 & Dem. State Gov.=0*), and 0 otherwise. Then, we interact these new dummies with the *KLD Net score*. In this specification we scale the KLD score to have a minimum of zero and a maximum of one, again to facilitate interpretation of results. The omitted group are funds with Democratic members and a Non-Democratic state government (*Democrat&NonDemstategov-Dummy)*. Thus, the coefficients on the interaction terms have to be interpreted as deviations from this category. Turning to the results presented in specification (3), the coefficient on the interaction term for the *Democrat&Demstategov-Dummy* is significantly positive, implying that funds with Democratic leaning members show an even stronger ESG preference if the state government is dominated by the Democratic Party. In comparison, we find a negative coefficient on the interaction terms for the *Republican&NonDemstategov-Dummy* and the *Republican&Demstategov-Dummy*. This suggests that funds with Republican members tilt away from companies with high ESG performance, independent of whether these funds might be subject to higher pressures by Democratic state politicians. One way of interpreting these findings is that the political leaning of funds' members is the dominant force behind funds' preferences for ESG investing. In comparison, political pressures from Democratic state politicians seem to merely have a moderating effect on funds' likelihood to engage in ESG.

Regarding the estimated coefficients on the control variables we find intuitive results. In terms of company characteristics, pension funds tend to invest more in larger companies as well as companies with lower book-to-market ratios, higher dividends, lower debt ratios and lower market risk exposure. Surprisingly, they also seem to increase their allocation to companies that

had a lower return in the previous quarter. Thus, the state pension funds in our sample do not seem to be momentum investors. Additionally, controlling for pension fund characteristics seems to be important as indicated by the statistically significant coefficients on all fund and state controls. While the results on most of these variables are difficult to interpret in this regression setting, the positive coefficient on the percentage of shares outstanding suggests that pension funds tilt their portfolio towards companies over which they can exercise greater control. This finding is in line with the reasoning in Fich et al. (2015).

5.2 KLD Subcategories

In this section, our aim is to identify the drivers of the relationship between the political proxies and the funds' ESG investing, by looking at the KLD subcategories. Instead of using the aggregated KLD Net score as a measure of a company's ESG activities, we run separate regressions for each of the seven KLD subcategories, i.e. corporate governance, community activities, diversity, employees' relations, environmental records, human rights and product quality. The results of these tests are presented in Table 7. Panel A focuses on the political leaning of the members by interacting the KLD subcategory scores with the *Democrat-Dummy*, whereas Panel B uses the *Dem. State Gov.-Dummy* instead. All specifications in Panel A and B show positive and highly significant coefficients on the interaction terms. This finding underlines that the identified relationships are a general trend towards ESG investing that incorporates all dimensions of ESG criteria and as such is not driven by a single KLD subcategory. It is noteworthy that the results hold for the human rights and corporate governance KLD categories which are often excluded in empirical studies (e.g. Hong & Kostovetsky, 2012; Krueger, 2015).[33] The identified relations also seem to be of similar economic dimension with human rights issues and community issues having the highest effect on portfolio choices, as measured by the absolute size of the estimated coefficients. This finding is partly in line with results presented in Krueger (2015) who analyses changes in shareholder value around CSR related (positive and negative) events. Krueger (2015) finds that shareholders seem to react most strongly to events related to communities and environment issues.[34] The relative uniformity of the estimates across subcategories also makes it less likely that the findings are driven by other unobservable differences in portfolio allocations between funds with Democratic and Republican leaning members as well as those with a Democratic and a Non-Democratic state government. For

[33] Hong & Kostovetsky (2012) exclude all of the aforementioned KLD subcategories from their analysis, while Krueger (2015) only excludes the corporate governance category. Hong, Kubik & Scheinkman (2012) show that the corporate governance subcategory of KLD differs from other KLD areas.

[34] Krueger (2015) uses CSR related events from a KLD database so that it can be assured that the classification of issues into subcategories such as communities' issues is consistent between our study and Krueger (2015).

example, if the documented ESG preferences were the result of state-specific policies, e.g. due to environmental catastrophes such as oil spills that affect specific states and might induce them to be more mindful of such factors, then we would expect to find strong results for single KLD subcategories but not such a uniform pattern.[35]

5.3 Change in Political Leaning

The results in section 5.1. suggest that the main determinant of state pension funds' ESG preferences is the political leaning of their members. In this section, we are interested in the dynamics of these preferences. In particular, we want to analyse whether a change in members' political leaning triggers an adjustment of the funds' portfolio towards or away from ESG companies and whether the direction of the portfolio adjustment depends on the type of the political change, i.e. from Republican to Democratic, or vice versa. With this analysis, we also aim to address potential endogeneity concerns of the relation between funds' portfolio allocations and politically-motivated ESG preferences. Arguably, the change in the political leaning of funds' members can be regarded as an exogenous shock as it is unlikely that fund members' political beliefs are affected by the ESG investment approach of their pension funds. To test the effect of changes in members' political leaning on funds' ESG investing, we first identify pension funds that experience a change in the political leaning of the state population during the four elections that took place over our sample. We find that 6 state pension funds experienced a change from Republican to Democratic leaning, while for 8 funds the political leaning changed from Democratic to Republican. For 68 cases, there was no change in members' political leaning over the presidential election. Of these 68 cases, 42 remained predominantly Democratic and 26 stayed Republican. For each election cycle and pension fund, we calculate the average residual portfolio-weighted *KLD Net score* for the four years prior to the election and the four years after the election.[36] We then take the difference between the pre- and post-election scores and perform a *t*-test on these differences. We do this for each of the subgroups sorted by the type of political change.

The results of this analysis are presented in Panel A of Table 8. Column 1 and 2 show the pre- and post-election KLD Net scores, respectively, while Column 3 reports the difference between post-

[35]We will more directly test for state-specific effects in the context of industry preferences in later robustness tests to make sure that results are not affected by preferences for certain industries and that results hold not only for the overall sample of S&P500 companies but also for industry subsamples within this group.

[36]If we do not have holdings data for the entire period we use the maximum number of quarters available for a particular election cycle. In unreported results, we repeat the analysis based on unadjusted portfolio-weighted KLD scores. We generally find support for our findings derived from the residual scores, though the results are slightly weaker highlighting the importance to adjust for size and value effects.

and pre-election scores along with the corresponding *t*-statistics. When the members' political leaning changes from Republican to Democratic, the then-Democratic leaning funds seem to tilt their portfolios towards ESG companies, as the positive and highly significant difference in average pre- and post-election KLD scores of 0.506 suggests. However, they do not seem to be able to entirely turn around the negative ESG focus of the portfolio as the average residual KLD score in the four years following the political change is still a negative -0.433. This might indicate that implementing an ESG orientated investment approach takes time to become effective. In comparison, a change from Democratic to Republican brings about an average negative change in funds' residual KLD scores of -0.942, changing from a positive pre-election score to a negative post-election figure. This suggests that the then-Republican funds seek a timely exit from potential ESG policies implemented under the previously Democratic leaning agenda. However, once the ESG policies are turned around Republican funds do not seem to consider ESG issues any longer as can be seen by the statistically insignificant difference of pre- and post-election KLD scores when the political climate of the state remains Republican. In contrast, the positive trend in ESG investing continues for those funds that stay Democratic and even tends to intensify as the political climate stabilises. The remaining columns of Panel A show the differences in post- and pre-election scores for the seven KLD subcategories. In order to preserve space we only present the differences in scores. Overall, the results for the subcategories generally support our findings based on the KLD Net score. For the change from Republican to Democratic leaning, we find the expected positive change for four out of seven subcategories. A change from Democratic to Republican leads to a decrease in the KLD scores in six out of seven cases. Remaining Republican does not significantly impact the ESG tilt of the portfolio, independent of the KLD subcategory, whereas staying Democratic results in an increase in funds' average ESG performance for all ESG subcategories, except for the diversity score.

In Panel B and C of Table 8 we repeat the same analysis but instead of looking at KLD Net scores we use the strength and concern scores to calculate differences between pre- and post-election values. This disaggregation of KLD Net scores helps us to understand what kind of ESG approach pension funds follow. For example, do Democratic pension funds target a stronger investment in companies that have high KLD strengths representing companies that actively promote ESG policies? Or do they aim to reduce their exposure to companies that commit or are more likely to commit violations in ESG areas as proxied by the KLD concern scores? For the KLD strength scores the data shows very similar patterns to the ones observed for the net scores. A change from a Republican to a Democratic climate is followed by a positive increase in funds' strength scores for six out of eight KLD specifications. Funds that changed from Democratic to Republican experience a decline in ESG performance for seven out of eight categories. However, the picture

becomes less clear when funds' members remain Democratic. There is a positive change for all but the corporate governance, community and diversity categories. Turning to the results for KLD concern scores, Panel C presents a very different picture regarding the dynamics of ESG preferences around political changes. We find that when a change in the state's political climate occurs, pension funds, on average, tilt more strongly towards companies with higher KLD concern scores, independent of the direction of the political change. In comparison, when the political leaning does not change, the average concern score of funds' portfolios decreases, though this decrease is insignificant for Republican funds. While a well-founded explanation of these findings requires additional analyses, the results nevertheless suggest some mechanisms that might be at place. Looking at the change from a Democratic to a Republican climate, companies with ESG concerns in the previously Democratic leaning funds tended to be underweighted (as indicated by the negative average pre-election KLD concern scores), e.g. due to negative screening and exclusion of "socially irresponsible" companies. However, with the strengthening of Republican influences these exclusions are made undone, resulting in an increase in the portfolio-weighted KLD concern scores. The increase in KLD concerns that follows a change from Republican to Democratic leaning is less intuitive. However, one route to explain these findings is that then-Democratic funds start to embrace an activist approach by targeting companies with concern scores, whereas after the phase of the initial activism they progressively tilt away from companies with ESG concerns. In order to confirm these potential explanations further analyses are needed which goes beyond the scope of this study. The main conclusion of the strength and concern analysis is, though, that pension funds seem to evaluate ESG strengths, i.e. ESG related policies that are actively put in place by companies, and ESG concerns, which represent ESG-related violations, differently. Democratic funds tend to reward companies that do well on ESG policies by systematically increasing their portfolio allocations towards these companies. In contrast, they do not seem to systematically penalise companies for ESG violations. Republican funds are more likely to unwind ESG policies after a political change, while from then onwards ESG considerations do not seem to play a significant role in their decision-making processes.

5.4 Introduction of the Principles for Responsible Investment

Next, we investigate whether the movement towards ESG investment as a whole has changed over time. We are especially interested in whether increased public interest for ESG themes and potential pressures to take a stand on ESG investing impacts funds' ESG preferences. We use the introduction of the PRI as such a structural break as it marks a change in the attitude and approach towards ESG investment (Woods & Urwin, 2010). The PRI were launched at the New York Stock Exchange in April 2006 after consultations with a group of institutional investors that

started in early 2005.[37] Since then the number of signatories and the amount of funds represented by these investors have constantly increased, starting from 32 signatories representing USD 2 trillion in April 2006 to nearly 1,300 signatories comprising assets worth over USD 45 trillion by the end of 2014.[38] By signing up to the PRI, institutional investors commit to incorporate ESG issues into their investment analysis and decision-making processes as well as to further promote the implementation of the PRI.[39] We argue that the introduction of the PRI has not only raised public awareness of ESG issues but it has also increased pressures on state pension funds, by both politicians and the general public, to take a stand on ESG investing. Based on these considerations we expect that from 2005 onwards, the identified relation between ESG investment preferences and the political leaning of the state has strengthened as funds from Democratic leaning states were responding to the call for incorporating ESG criteria into their investments whereas Republican leaning funds remained immune to such pressures.

To test this conjecture, we subdivide the overall sample into two sub-periods. The first sub-period runs from 1997Q1 to 2004Q4 and thus spans the time prior to the development and launch of the PRI. The second sub-period comprises quarters 2005Q1-2013Q4. Results are presented in Table 9. As expected, we find a stronger relation between members' Democratic leaning and a fund's ESG investing after the launch of the PRI, in terms of both the statistical significance and the economic magnitude of the effect.[40] Regarding the impact of political pressures on funds' ESG preferences (specifications 2 and 5), we also find an increase in the statistical and economic significance, although the differential effects are considerably smaller than for members' political leaning. Finally, the combined effect of members' political leaning and pressures by politicians (found in section 5.1.) only becomes present in the second half of the sample (specification 6), whereas these effects cannot be observed prior to the launch of the PRI (specification 3). This supports our interpretation of these findings as indication that the establishment of the PRI has increased pressures on pension funds to position themselves regarding ESG investing and that some of these pressures might be exercised by state politicians. However, we are cautious in relating this development solely to the PRI.

[37] See http://www.unpri.org/about-pri/about-pri/history/. Interestingly, some of the state and local pension plans in our sample are among the founding and drafting members of the PRI.

[38] See PRI 2014 Annual Report http://2xjmlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/PRIAnnualReport2014.pdf.

[39] See http://www.unpri.org/about-pri/the-six-principles/ . The PRI initiative involves six general principles, of which the principle to incorporate ESG issues into investment analysis and decision-making processes, is the first and most central principle. The other principles evolve around supporting active ownership and disclosure on ESG issues as well as promoting the implementation of the PRI.

[40] We repeat these analysis for different adjustments of the portfolio weights as described in Section 7.1 and 7.2 and find that our findings hold, independent of the portfolio weight proxy that is being applied. The results are presented in Table D.1 in Appendix D.

6 Performance Effect of Politically-Motivated ESG Investing

The question of the performance effects of ESG activities by state public pension funds is of particular interest in light of the heated debate whether ESG investing is in line with the fiduciary duty of a pension fund.[41] The opponents of ESG investing argue that public pension funds should only base their investment decisions on risk and return considerations as "social investing subverts a fiduciary's common-law duty of undivided loyalty" and serves as a "vehicle for political mischief at the expense of the interests of taxpayers" (Rounds, 2005: 76; also Entine, 2005). In contrast, the supporters of ESG highlight that incorporating ESG factors into investment decisions mitigates the exposure to long-term risks and is in the interest of pension funds' beneficiaries. Thus we ask: What are the performance effects of the politically motivated ESG investments? To analyse pension funds' performance, we follow two approaches. In section 6.1., we build portfolios based on funds' political environment, their holdings' ESG performance and their deviations from benchmark weights. We then compare the (risk-adjusted) performance of these portfolios. In section 6.2., we undertake a multivariate panel analysis of fund performance that directly controls for fund and state effects.

6.1 Calendar Time Portfolio Approach

For the calendar time portfolio approach, we first compute the monthly portfolio returns for each state pension fund in our sample. As we only have a very limited number of quarterly holdings for some of the funds, we restrict the sample in this sub-section to funds with at least 25 quarters of holdings data. After this restriction our sample is reduced to 18 state pension funds.[42] To construct monthly returns on a fund's S&P500 holdings, we weight each holding by its weights in the portfolio at the end of the previous quarter and re-balance the portfolios at the

[41] According to the 'traditional' interpretation of pension funds' fiduciary duties, a pension fund should follow certain generally accepted principles such as utilizing diversification to achieve competitive risk-adjusted returns in accordance with the risk parameters specified in the investment policy. All decisions are to be made in good faith for the economic benefit of the beneficiaries (e.g. Freshfields Bruckhaus Deringer, 2005; Richardson, 2007). While for private pension funds in the U.S., the Employee Retirement Income Security Act of 1974 (ERISA) prohibits investment decisions based on any factors other than economic or financial objectives public pension funds are exempt from this law and are instead regulated by the state. This often includes that the state prescribes the fund's investment policy or designates public pension fund boards. However, legally, public pension funds are not directly controlled or owned by the state but are a government-sponsored fund with an independent board of trustees. For a detailed discussion on the debate whether the incorporation of ESG factors into the investment process violates pension funds' fiduciary duty please refer to e.g. Rounds, 2005; Freshfields Bruckhaus Deringer, 2005; Sethi, 2005; Richardson, 2007; Sandberg, 2011; Hoepner, Rezec & Siegl, 2011.

[42] These funds include: CalPERS, CalSTRS, ColoradoPERA, FloridaSBA, KentuckyRetS, KentuckyTRS, MichiganTreas, NJInvB, NYStateComRS, NYStateTRS, NewMexicoERB, OhioPERS, OhioTRS, PennPSERS, TexasERS, TexasTRS, VirginiaRS and WisconsinIB.

end of the consecutive quarter based on the new portfolio weights. This approach ignores any return effects from intra-quarter trading. Besides calculating a fund's return on its entire S&P500 holdings, we next create portfolios sorted by deviations from benchmark weights as well as the holding's ESG performance. We calculate the absolute deviation from the S&P500 by deducting the weight of a company in the S&P500 index from the portfolio weight of that company in a fund's portfolio.[43] Then, we rank the holdings of a fund according to the deviations from S&P500 weights. We create a portfolio of a fund's most overweighted holdings (i.e. the holdings that rank in the 4th quartile of holdings ranked by deviations from the S&P500) and a portfolio of its most underweighted holdings (i.e. the first quartile of holdings ranked by S&P500 deviations). We repeat this exercise for holdings' ESG performance, by creating a portfolio that contains the holdings with the highest ESG scores (i.e. the 4th quartile of holdings ranked by *KLD Net score*) and one for holdings with the lowest ESG scores (i.e. the first quartile of stocks ranked by *KLD Net score*).[44] Finally, we perform a double sorting by creating portfolios that comprise (a) the most overweighted holdings with the highest ESG performance (i.e. 4th and 4th quartile, respectively), (b) the most underweighted holdings with the lowest ESG performance (1st and 1st quartiles), (c) the most overweighted holdings with the lowest ESG performance (4th and 1st quartiles), and (d) the most underweighted holdings with the highest ESG performance (1st and 4th quartiles). We accumulate portfolio returns across all 18 funds.

We run monthly time series regressions applying a calendar time portfolio approach with quarterly rebalancing. The advantage of this approach is that it avoids issues of cross-sectional correlations of abnormal returns (Fama, 1998). In Panel A of Table 10, we report alphas estimates of the portfolios described above estimated based on a Fama-French three-factor model plus Carhart's (1997) momentum factor. The dependent variable is the monthly value-weighted portfolio return. In contrast to the traditional four factor model, we do not employ the overall market return as the market factor but use the S&P500 return instead as it more closely fits our setting.[45] Specification (1) reports results for the portfolio including all 18 pension funds. It neither significantly out- nor underperforms on the whole S&P500 holdings (row (A)) or any of the portfolios sorted by ESG performance or deviations from benchmark weights (rows (B) to (I)). To rule out any differential effects in portfolio performance with respect to deviations and ESG performance, we also construct long-short portfolios which are reported in the last four

[43]Details on the calculations of the deviation proxy can be found in section 7.2.

[44]Again, these portfolios are value-weighted portfolios, based on the dollar value of each holding in a fund's portfolio. In unreported results we confirm the robustness of our findings to sorting portfolios based on the first and third tercile of deviations from the S&P500 weights and of ESG performance.

[45]In order to make the return calculations of the market factor and the portfolio returns exactly comparable, we do not use the readily downloadable S&P500 return but calculate the returns by weighting each S&P500 stock in our sample by its market value.

rows of Panel A. Even the long-short portfolios do not generate a significantly positive or negative alpha.

However, the risk factors of the four factor model do not account for different industry loadings. As Brown et al. (2015) demonstrate and as we will show in the robustness tests in section 7.1., state pension funds differ regarding their industry allocations. They have the tendency to overweight in-state industries. To account for potential industry effects as well as international risk factors we extend the four-factor model to a three-level Fama-French model. This model is similar in spirit to the factor models presented in Gregory & Whittaker (2007), Hoepner, Rammal & Rezec (2011) and Karolyi & Wu (2012). In particular, we introduce to the standard four-factor model a global market factor, global size, value and momentum factors as well as ten industry factors representing the ten Fama-French sectors for the U.S. market. However, as the global and industry factors are expected to be highly correlated with the standard four risk factors this poses concerns of multicollinearity. To capture only the additional explanatory effect of each added factor, we use the orthogonalisation approach by Elton, Gruber, Das & Hlavka (1993) which offers an accurate statistical correction for the influence of the already included factors.[46] The model can be expressed as follows:

$$\begin{aligned} r_{p,t} = \alpha_p + \beta_{S\&P} r_{S\&P,t} + \beta_{SMB,US} SMB_{US,t} + \beta_{HML,US} HML_{US,t} + \beta_{MOM,US} MOM_{US,t} + \beta_{m,glob} r^{orth}_{m,glob,t} \\ + \beta_{SMB,glob} SMB^{orth}_{glob,t} + \beta_{HML,glob} HML^{orth}_{glob,t} + \beta_{MOM,glob} MOM^{orth}_{glob,t} \\ + \sum_{i=1}^{10} \beta_{k,ind,US} r^{orth}_{k,ind,US,t} + \epsilon_t \end{aligned} \quad (3)$$

where $r_{p,t}$is the excess portfolio return, $r_{S\&P,t}$ is the excess S&P500 return, $SMB_{US,t}$, $HML_{US,t}$, and $MOM_{US,t}$ are the size, value and momentum factors for the U.S. market, respectively, $r^{orth}_{m,glob,t}$ is the orthogonalised return of the MSCI World index, $SMB^{orth}_{glob,t}$, $HML^{orth}_{glob,t}$ and $MOM^{orth}_{glob,t}$ are the orthogonalised global size, value and momentum factors, respectively, and $r^{orth}_{k,ind,US,t}$ is one of the orthogonalised Fama-French 10 sector portfolios for the U.S. market. All added global and industry factors are orthogonalised against $r_{S\&P,t}$.

The alphas obtained from estimating equation (3) are presented in Panel B of Table 10. Our results suggest that it is important to control for the two additional levels of risk as shown by the now significant alphas for some of the portfolios. Interestingly, we find that the funds underperform on their holdings of S&P500 companies and that this underperformance is caused

[46]This approach has also been employed by Hoepner et al. (2011) in the context of Islamic mutual funds. The authors note that "[t]his approach cleans a factor X from the impact of other factors Y by regressing it on them and replacing factor X by the sum of the intercept and the residuals of the regressions" (Hoepner et al., 2011: 841-842).

by an underperformance on their most overweighted holdings and an outperformance of the most underweighted holdings, suggesting that the funds in our sample exhibit weak stock picking skills. However, this underperformance does not seem to be related to their allocations to ESG holdings. If at all, the funds slightly outperform on their holdings with a high ESG performance. However, it is important to note that we are still looking at the aggregate of all 18 funds. Thus, next we analyse the performance effects if we condition on the political environment of the funds. We construct portfolios that only include funds with Democratic members (specification 2), with Republican members (specification 3), with a Democratic state government (specification 4) and with a Non-Democratic state government (specification 5). Additionally, we generate long-short portfolios to capture the differential effects for funds with Democratic versus Republican members and Democratic state government versus Non-Democratic state government. Looking at Panel A, we find that almost none of the alphas generated from the standard four-factor model are statistically significant for these portfolios, with the exception of the long-short portfolio for the Dem. State Gov. versus Non-Dem State Gov. portfolio. The latter seems to significantly outperform on the overweighted holdings with high ESG performance and significantly underperforms on the underweighted holdings with low KLD Net scores. Turning to the results of model (3) reported in Panel B, we find that there are no major differences in the performance patterns between all 18 funds and the subgroup of funds sorted by political proxies. The most noteworthy findings from this analysis include the significant performance difference in the holdings with high and low ESG performance for funds with Democratic members and those with Republican members. However, once we condition on deviations from the S&P500 and the ESG performance this significant performance difference disappears, suggesting that potential advantages from picking well performing ESG stocks do not translate into actual outperformance. Overall, the results from the portfolio based performance analysis indicate that state pension funds show weak stock picking ability. They tend to overweight underperforming stocks and underweight outperforming stocks. However, their underperformance is not consistently related to the politically-motivated ESG investing.

6.2 Multivariate Panel Analysis of Pension Fund Equity Performance

Following Bradley et al. (2015), we also estimate fund performance in a multivariate panel setting. This enables us to more directly control for pension fund or state specific effects that might affect fund performance. We estimate the following fixed effect panel regression:

$$r_{j,t} = \beta_0 + \beta_1 KLD_{jt}^{pfw} + \beta_2 KLD_{jt}^{pfw} \times political\ proxy_{jt} + \beta_3' fund\ controls_{jt} + v_j + \epsilon_t \quad (4)$$

where r_{jt} is the quarterly portfolio-weighted return of fund j over quarter t, KLD_{jt}^{pfw} is the average portfolio-weighted KLD Net score of fund j at quarter t, $political\ proxy_{jt}$ is one of the political dummies employed in section 5.1, and $fund\ controls_{jt}$ is a column vector including the fund and state specific effects (except for *% shares outstanding*). For all model specifications, standard errors are clustered at the pension fund level to correct for serial correlation in residuals. We include pension fund fixed effects (v_j) to absorb time invariant characteristics within a pension fund. In alternative specifications we use quarter fixed effects instead to exploit variation across funds and also include both fund and quarter fixed effects. The results of running model (4) are presented in Table 11. Panel A presents results when we condition on the political leaning of funds' members using the *Democrat-Dummy* (specifications 1-3) and on the composition of the state government (specifications 4-6). Across all six specifications, we find a positive and significant relation between funds' portfolio-weighted KLD score and their quarterly portfolio return, implying that funds with a higher ESG performance of their holdings generate higher returns. However, we do not find that this relation depends on the political environment of the fund as indicated by the insignificant coefficient estimates for the interaction terms of the KLD score and both political proxies. Additionally, our results do not suggest consistent performance differences between funds with Democratic or Republican members as well as a Democratic or Non-Democratic state government, as can be seen by the (mainly) insignificant coefficients on the standalone *Democrat-Dummy* and *Dem. State Gov.-Dummy*. In Panel B, we repeat the above analysis but substitute the political proxies for the dummies that conditional on both, the political leaning of funds' members and the composition of the state government. Again, the results do not suggest significant performance differences related to the political environment. The only remarkable result is that the positive relation between the standalone portfolio weighted KLD score and the fund performance becomes insignificant in the model specifications that include both fund and quarter fixed effects. Overall, the results of the multivariate analysis are in line with those of the portfolio approach in section 6.1, namely that the politically-motivated ESG investments do not result in financial under- or outperformance. They are also in line with previous research by Hong & Kostovetsky (2012) and Di Guili & Kostovetsky (2014) which suggests an attitude-driven rather than a financially-motivated preference for ESG. Hong & Kostovetsky (2012) find that the overall performance of Democratic and Republican mutual fund managers does not differ, despite their different loadings on ESG stocks. The results in Di Guili & Kostovetsky (2014) indicate that corporate ESG policies are costly. Thus the authors argue that Democratic leaning managers and founders of the companies that engage in ESG activities must obtain "indirect value" from these investments, e.g. by aligning their actions with their political beliefs.

7 Alternative Explanations and Robustness Tests

7.1 Industry Adjustments

In this and the following sections we test alternative explanations for our finding of a positive relation between the political leaning of members and funds' overweighting of ESG companies. First, we analyse whether the identified relations are an artefact of the tendency of U.S. state pension funds to overweight in-state industries. Previous research has shown that these funds tend to overweight stocks from industries that are dominant in their home state (e.g. Brown et al., 2015).[47] Additionally it is a well-known fact that a company's ESG performance is highly dependent on the sector and industry that it operates in. For example, companies in the IT sector tend to have consistently higher ESG ratings than oil and gas companies which tend to perform poorly on ESG issues.[48] If the pension funds in our sample overweight their in-state industries and the dominant industries in states with a Democratic leaning population happen to have a high average KLD score while the dominant industries in Republican leaning states show poor ESG performance, this would result in the same findings as presented earlier. However, in this case we would not pick up funds' preferences for ESG but their general industry preferences. In order to check that our findings are not a result of industry over- or underweighting, we adjust the portfolio weights in the following way:

$$w_{ijt}^{ind.} = \frac{val_{ijt}}{\sum_i^N val_{ijt}^{ind.}} \quad ,$$

where $w_{ijt}^{ind.}$ is the industry-adjusted portfolio weight, val_{ijt} is the value of company *i* held by pension fund *j* at the end of a quarter *t* and $\sum_i^N val_{ijt}^{ind.}$ is the value of holdings in the Fama-French sector that company *i* operates in held by pension fund *j* at the end of quarter *t*.[49] Thus, $w_{ijt}^{ind.}$puts the focus on the kind of companies a fund invests in within a particular industry and mitigates the potentially biasing effect if a fund is overinvested in a particular industry.

[47]We analyse how closely the funds in our sample follow the market market industry allocations by calculating the average weight that the pension funds hold in each of the 10 Fama-French sectors and comparing it to the average weight of that sector in the S&P500 index. The results are presented in Table D.2 of Appendix D. We find that funds do not strictly follow the market weights but (to a varying degree) tilt towards certain sectors.

[48]These patterns are supported in our data (Table D.2 of Appendix D, row 2). Companies operating in the 'Oil, Gas and Coal Extraction and Products' sector have a negative mean KLD Net score of -2.454, similar to companies in the Utilities sector (-0.468), whereas companies operating in the Business Equipment sector or the Consumer Non-Durables sector tend to have strong KLD Net scores of 1.793 and 0.751, respectively.

[49] In unreported results, we also apply the Fama-French 48 industries and the GICS sector and industry classifications. Our main results are qualitatively unchanged.

Panel A in Table 12 reports results of the baseline regression when we substitute the simple portfolio weights with the industry-adjusted weights. Our main results are not affected by funds' industry preferences. We still find a significantly positive coefficient on the interaction term with the *Democrat-Dummy* (specification 1) and the *Dem. State Gov.-Dummy* (specification 2). Even the interactions with the dummies based on both members' political leaning and the composition of the state government exhibit the expected signs (specification 3). As an alternative way to test for industry effects, we run separate regressions for each of the 10 Fama-French sectors. We also re-estimate the baseline regression including industry fixed effects. The results of these analyses are presented in Appendix D Table D.3 and D.4, respectively. Again our findings remain robust to these industry controls.

7.2 Deviations from Benchmark Weights

Parrino at al. (2003) report that a substantial proportion of a state pension fund's portfolio is indexed, i.e. the weight that a company has in a fund's portfolio follows the weight of that company in the index. Additionally, there is broad evidence that fund managers' investment performance is evaluated against a benchmark, incentivising managers not to deviate too strongly from benchmark weights (e.g. speech by Jim Leech, President and CEO of Ontario Teachers' Pension Plan at the 2013 Asset and Risk Allocation Conference in New York City, 15-16 April; or Del Guercio & Tkac, 2002). Recent research suggests that deviations from benchmarks and norms are especially informative with respect to superior information and investor preferences (e.g. Kumar & Page, 2014).[50] Considering that U.S. state pension funds are major market participants and fiduciaries to millions of American citizens their investment choices are closely monitored and this monitoring might constraints them in their tendency to deviate from market benchmarks (see also Hong & Kacperczyk, 2009). Therefore, deviations from benchmark weights might be more informative of funds' investment preferences than simple portfolio weights as the latter could be heavily affected by indexing. We construct two alternative portfolio weight proxies that measure funds' deviation from the S&P500 benchmark. First we calculate the absolute deviation from the S&P500 by deducting a company's weight in the S&P500 index from its portfolio weight in the fund's portfolio:

$$abs.dev.w_{ijt} = w_{ijt} - w_{it}^{S\&P500},$$

where w_{ijt} is the portfolio weight of company *i* in fund *j*'s portfolio relative to fund *j*'s total holdings in S&P500 companies at the end of quarter *t* and $w_{it}^{S\&P500}$ is the weight of company *i* in

[50] Kumar & Page (2014) show that when norm-restricted investors deviate from their norms then these investments represent superior information or particular preferences of the managers and tend to result in superior performance.

the S&P500 index at the end of quarter *t*. Thus, if a pension fund's portfolio weight in a company relative to its total holdings in the S&P500 exactly resembles the S&P500 weight $abs.dev.w_{ijt}$ takes the value of zero. An overweighting (underweighting) of a company with respect to the S&P500 results in a positive (negative) value for $abs.dev.w_{ijt}$. Additionally, we construct a variable that measures the relative deviations from the S&P500 weights, as:

$$rel.dev.w_{ijt} = \frac{w_{ijt}}{w_{it}^{S\&P500}}.$$

For $rel.dev.w_{ijt}$, a value of one indicates that the fund exactly follows the S&P500, whereas a value larger (smaller) than one points to overweighting (underweighting).

Panel B in Table 12 reports results when we replace the simple portfolio weights, w_{ijt}, with the two deviation proxies as dependent variables. In line with our previous results, we find a positive relation between funds' ESG preferences and the Democratic leaning of their members as well as the power of the Democratic Party in the state government (specifications 4-7). However when turning to specifications (8) and (9) where we test the combined effect of the political proxies, we only find partial support for our initial findings. When focusing on the absolute deviation proxy we still find the expected relations, though the interaction term with the *Democrat&Demstategov-Dummy* becomes insignificant. However, the specification with the relative deviations from the S&P500 only partially supports our previous findings. In specification (9) the funds with Republican members and a Democratic state government show the strongest preference for ESG investing, whereas the ESG preferences of funds with Democratic members and a Democratic state government are weaker than expected. Thus, we need to be cautious when making inferences for the combined effects of the political proxies.

7.3 Alternative Political Proxies

In this section, we use alternative political proxies to rule out that the results are an artefact of the employed proxies. The results of these tests are presented in Table 13. Appendix B describes the construction of the variables and Table D.5 provides summary statistics and a correlation matrix of the different proxies to assess their relation to one another. We employ the following alternative proxies: (a) the percentage of votes received by the Democratic candidate in the latest presidential elections, i.e. *% of Democratic votes*, (specification 1); (b) the proportion of the state government affiliated to the Democratic Party, i.e. *% of Dem. State Gov.* (specification 2); (c) the political affiliation of the State Treasurer, i.e. *Dem. State Treasurer-Dummy* (specification 3); (d) the political affiliation of the State Governor, i.e. *Dem. Governor-Dummy* (specification 4); dummies that condition on both, fund members' political leaning and the State Governor's political affiliation (specification 5); (e) the composition of the state's delegation to the U.S.

Congress, i.e. *Dem. State Delegation-Dummy* (specification 6); and dummies conditioning on both fund members' political leaning and the composition of the state congress' delegation (specification 7). The results support our previous finding that the affiliation towards the Democratic Party and its political agenda are important determinants of funds' ESG preferences. Additionally, we find that the proxies capture distinct aspects of states' political climate as evidenced by the low correlations between variables (Table D.5, Appendix D).

7.4 Extended Dataset

Our previous analyses are based on comparisons relative to funds' holdings in companies that are constituents of the S&P500 index. The main rationale for this approach is to prevent any time bias due to the several extensions of KLD's company coverage in the early 2000's. In this section we test whether our results remain robust to including these additional companies.[51] Results are presented in Table 14. In specifications (1)-(3) we employ the company's weight with respect to the fund's entire holdings in companies with a KLD rating for quarter t (${w_{ijt}}^{extd}$). Specification (4)-(6) use the industry-adjusted version of these portfolio weights (${ind.-adj.w_{ijt}}^{extd}$). We find that our main results regarding the impact of members' political leaning for funds' ESG preferences are qualitatively unchanged (specification 1-4), showing that our findings extend beyond the S&P500 universe. Interestingly, the effect of political pressures by state politicians becomes insignificant or even negative in the extended dataset (specification 2-5), confirming that these pressures are merely a moderating factor.

7.5 Variations of the KLD Scores

As a final robustness test, we check whether our results remain robust to different ways of calculating the KLD scores. First, it can be argued that not all KLD subcategories are strongly related to the Democratic political agenda. As pointed out in Hong & Kostovetsky (2012) and Di Guili & Kostovetsky (2014), issues of corporate governance and product quality cannot be clearly connected to either party platform but should be of concern to both parties alike. Additionally, the human rights category has very few items that are consistently rated over the entire sample period. To ensure that our findings are not driven by these three subcategories, we re-estimate the baseline regressions using a KLD Net score that excludes these categories. The results are presented in Table 15, specifications (1)-(3). They are qualitatively unchanged and in their statistical and economic magnitude almost identical to the baseline results.

[51] Figure 1 allows an evaluation of the effect of these additions on the overall holdings covered by our tests.

Moreover, the way that KLD scores are calculated has seen several changes over our sample period; the most drastic change in 2009 relating to the acquisition of KLD by RiskMetrics, now a subsidiary of MSCI. In this context, KLD has significantly altered the computation of the KLD scores. One result of these adjustments is that the KLD scores tend to be inflated since 2009. To rule out that our findings are the result of this methodological change, we exclude all observations from 2009 onwards and re-run model (2) based on the subsample 1997Q1-2008Q4 (Table 15, specifications 4-6). We still find strong support for the positive relation between members' Democratic leaning and funds' tilt towards ESG companies. However, in specification (5) the effect of political pressures by Democratic state politicians reverses.

Kotchen & Moon (2012) point out that some of the items in the KLD subcategories have been added or removed over the years. Thus, the aggregated scores might lack comparability over time. We follow Kotchen & Moon (2012) and Hong & Liskovich (2014) and normalise the KLD scores with respect to each KLD subcategory and each year such that each subcategory score has a mean of 0 and a standard deviation of 1 for each year. Then, we aggregate the normalised scores per year and generate an overall normalised KLD Net score, which we standardise to an overall minimum of zero. Specifications (7)-(9) show that our results are not significantly affected when using this alternate measures of ESG performance.

8 Conclusion

In this study, we provide empirical evidence that political factors impact the investment decisions of state pension funds by studying the equity holdings of 31 U.S. state pension plans. We analyse whether political factors help to explain the heterogeneity of these funds' ESG activities, as measured by the ESG performance of their equity holdings. We find strong support that funds with Democratic leaning members tilt their portfolios more strongly towards companies that perform well on ESG issues as compared to their Republican counterparts. Additionally, we find that political pressures by state politicians have a moderating effect on funds' ESG investment approach: Funds with a Democratic leaning membership base show a stronger ESG preference when the state government is predominantly affiliated to the Democratic Party. In contrast, funds from states with Republican leaning members do not seem to engage in ESG investing, even if the state government is predominantly composed of Democrats. Furthermore, pension funds seem to alter their portfolio allocations around changes in members' political leaning to align their ESG investment policies with members' attitudes towards ESG issues. Finally, we find that the sample funds neither under- nor outperform on their politically-motivated ESG holdings. This provides initial evidence that their ESG preferences are

not purely motivated by risk and return considerations, but might also be driven by their members' political values.

Our findings have important implications for the literature on ESG investing by institutional investors, the management of state pension funds and the promotion of ESG investing in financial markets. They suggest that even on an institutional level ESG investments may be driven strongly by investors' attitudes towards the social aims of firms (as compared to pure risk and return considerations of ESG issues). Moreover, our results relate to the fiduciary duty debate around state pension funds' ESG investing. We provide some support that these practices are not detrimental to beneficiaries' financial wealth but instead might provide beneficiaries with indirect utility as their pensions are invested in accordance with their own political values and beliefs. Finally our finding that the investment decisions of such a large group of investors with enormous market power are affected by the political attitudes of their members could have larger effects on financial markets as a whole. Considering that the largest of these funds have assets under management between USD 200-300 billion, changes in funds' ESG preferences due to changes in states' political climate may trigger great channelling of money in or out of ESG investments. This might substantially impact firms' cost of capital and the promotion of ESG investing in financial markets. However, more research is needed to understand the investment preferences of U.S. state public pension funds and how these are impacted by political factors. One route for future research is to analyse whether the effects of members' political leaning and pressures by state politicians also extend into other areas of pension funds' investment choices, such as the hiring of external managers or their inclination to engage in ESG shareholder activism.

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Table 1 - Summary Statistics: U.S. State pension fund Sample

Table 1 reports the names of the 31 U.S. state and local pension plans in our sample, together with further summary statistics at the pension-fund level. *Abbreviation* represents the abbreviated name of the pension plan used in this study. *State* is the U.S. state that the pension plan is located in. *Q* is the number of quarters for which we have available holdings data. *Shares* represents the time-series average of the number of S&P500 companies held by the pension plan. *KLD Score* is the time-series average of quarterly cross-sectional means of the KLD Net Score of the holdings of a pension plan. The KLD Net Score is defined as the sum of net scores (i.e. strength score minus concern score) for the KLD subcategories corporate governance, community activities, diversity, employee relations, environmental records, human rights and product quality. A pension fund's KLD score is the average KLD score of its portfolio stock components, weighted by the portfolio weight held in each stock.

	Name of the Pension Fund	Abbreviation	State	Q	Shares	KLD Score
1	Alaska Retirement Management Board	AlaskaRMB	AK	31	25	0.04
2	Arizona Safety Personnel Retirement System	ArizonaSafePERS	AZ	24	75	0.74
3	Arizona State Retirement System	ArizonaStateRS	AZ	11	499	4.24
4	California Public Employees' Retirement System	CalPERS	CA	68	492	1.16
5	California State Teachers' Retirement System	CalSTRS	CA	68	486	1.17
6	Colorado Public Employees' Retirement Association	ColoradoPERA	CO	68	493	1.13
7	Florida State Board of Administration	FloridaSBA	FL	68	489	1.15
8	Illinois Municipal Retirement System	IllinoisMunRS	IL	8	488	0.01
9	Kentucky Retirement Systems	KentuckyRetS	KY	38	428	0.73
10	Kentucky Teachers' Retirement System	KentuckyTRS	KY	68	495	1.06
11	Louisiana State Employees' Retirement System	LouisianaSERS	LA	1	498	4.18
12	Michigan Municipal Employees' Retirement System	MichiganMunERS	MI	2	498	4.18
13	Michigan Treasury	MichiganTreas	MI	68	496	1.26
14	Montana Board of Investments	MontanaInvB	MT	24	73	0.62
15	New York City Employee Retirement System	NYCityERS	NY	8	36	-0.08
16	New Jersey Board of Investments	NJInvB	NJ	68	377	1.06
17	New York State Common Retirement System	NYStateComRS	NY	68	498	1.09
18	New York State Teachers' Retirement System	NYStateTRS	NY	68	490	1.06
19	New Mexico Educational Retirement Board	NewMexicoERB	NM	68	446	1.01
20	Ohio Public Employees Retirement System	OhioPERS	OH	68	494	1.11
21	Ohio State Teachers' Retirement System	OhioTRS	OH	68	461	1.06
22	Oregon Public Employees' Retirement System	OregonPERS	OR	17	499	3.05
23	Pennsylvania Public School Employees' Retirement System	PennsylvaniaPSERS	PA	55	498	0.99
24	South Dakota Board of Investments	SouthDakotaInvB	SD	24	253	0.46
25	Tennessee Consolidated Retirement System	TennesseeConsRS	TN	24	376	0.74
26	Texas Employees' Retirement System	TexasERS	TX	62	487	1.27
27	Texas Teachers' Retirement System	TexasTRS	TX	27	461	1.95
28	Utah Retirement Systems	UtahRS	UT	6	414	3.58
29	Virginia Retirement System	VirginiaRS	VA	68	443	1.07
30	Washington State Investment Board	WashingtonStateIB	WA	11	11	1.02
31	Wisconsin Investment Board	WisconsinIB	WI	68	386	1.15
	Total			43	392	1.11

Table 2 - Summary Statistics: KLD Scores of S&P500 Companies

Table 2 reports summary statistics of the average KLD Scores for the 950 companies that are constituents of the S&P500 index during the sample period. *Overall KLD Net* score is the sum of all net scores (i.e. strength score minus concern score) for the 7 KLD subcategories corporate governance, community, diversity, employee relations, environmental record, human rights and product quality, which are reported in Columns 3 to 9. The sample comprises the period 1997Q1 to 2013Q4. The unit of observation is at the *security×quarter level*. Further details on the variable definition and construction can be found in Appendix A.

	Overall KLD Net	**Corp. Gov. Net**	**Community Net**	**Diversity Net**	**Employee Rel. Net**	**Environment Net**	**Human Rights Net**	**Product Quality Net**
Mean	0.43	-0.50	0.30	0.99	0.16	-0.01	-0.10	-0.40
Standard Deviation	3.48	0.78	0.85	1.55	1.23	1.21	0.40	0.93
Median	0.00	-1.00	0.00	1.00	0.00	0.00	0.00	0.00
Kurtosis	4.54	3.62	5.37	3.65	5.52	5.86	11.66	4.31
Skewness	0.62	0.00	1.04	0.85	0.72	-0.14	-1.94	-0.91
Range	30.00	6.00	7.00	10.00	11.00	10.00	5.00	7.00
Minimum	-11.00	-4.00	-2.00	-3.00	-4.00	-5.00	-3.00	-4.00
Maximum	19.00	2.00	5.00	7.00	7.00	5.00	2.00	3.00
N	33,966	33,966	33,966	33,966	33,966	33,966	33,966	33,966

Table 3 - Summary Statistics and Correlation Matrix: Main Variables

Panel A reports summary statistics for the main variable of analysis. Panel B shows a correlation matrix of the major independent variables used in the regression models. The unit of observation is the *fund×security×quarter level*. Further details on the variable definition and construction can be found in Appendix A.

Panel A: Summary Statistics	**Mean**	**Std.-Dev.**	**Median**	**Min.**	**Max.**	**5th Perc.**	**95th Perc.**	**N**
Portf. Weight in S&P500 (w_{ijt})	0.23	0.48	0.09	0.00	18.75	0.01	0.94	574,151
% of Votes for Democratic Party	0.50	0.07	0.51	0.25	0.63	0.39	0.61	574,151
Democrat-Dummy	0.64	0.48	1.00	0.00	1.00	0.00	1.00	574,151
% of Dem. State Gov.	0.42	0.36	0.50	0.00	1.00	0.00	1.00	574,151
Dem. State Gov.-Dummy	0.32	0.47	0.00	0.00	1.00	0.00	1.00	574,151
KLD Net Score	0.51	3.55	0.00	-11.00	19.00	-5.00	7.00	574,151
Log Market Capitalisation	16.17	1.16	16.09	11.47	20.26	14.37	18.28	574,136
Log Book-to-Market Value	-0.97	0.80	-0.91	-6.80	2.93	-2.31	0.18	565,422
Lagged Dividend Yield	0.02	0.04	0.01	0.00	1.95	0.00	0.06	574,151
Lagged Debt Ratio	0.25	0.17	0.24	0.00	1.56	0.00	0.56	574,151
Lagged Return on Assets	0.05	0.10	0.05	-4.58	0.57	-0.03	0.16	574,151
Lagged Beta Coefficient	1.09	0.72	0.99	-2.52	5.76	0.15	2.41	561,160
Lagged Log Security Return	0.01	0.19	0.03	-2.07	1.31	-0.32	0.28	573,825
Log Fund Size	18.14	1.82	17.88	14.89	24.44	16.04	24.11	521,699
% invested in Equities	56.81	8.83	58.35	23.00	72.78	39.90	67.70	521,699
Funded Ratio	88.39	16.02	87.32	42.73	144.62	61.50	114.40	560,476
% of Share Outstanding Held	0.18	0.39	0.11	0.00	42.36	0.01	0.50	514,292
Political Corruption Convictions	0.35	0.19	0.32	0.00	2.20	0.11	0.72	574,151
% Union Members	40.00	19.58	46.00	8.40	72.40	14.10	70.20	574,151
S&P500 Return	0.02	0.11	0.03	-0.35	0.25	-0.18	0.15	574,151

Panel B: Correlations	**(1)**	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**	**(9)**	**(10)**	**(11)**	**(12)**	**(13)**	**(14)**	**(15)**
(1) KLD Net Score	1														
(2) Market Cap.	0.19	1													
(3) BtM Value	-0.11	-0.22	1												
(4) Dividend Yield	-0.01	-0.01	0.15	1											
(5) Debt Ratio	-0.09	-0.07	0.02	0.16	1										
(6) Return on Assets	0.08	0.17	-0.32	-0.03	-0.15	1									
(7) Beta Coefficient	0.00	-0.14	0.07	-0.14	-0.13	-0.20	1								
(8) Security Return	0.01	0.12	0.06	0.02	-0.01	0.03	-0.07	1							
(9) Fund Size	0.01	-0.01	0.01	0.00	-0.01	0.01	0.00	0.00	1						
(10) % Equities	-0.13	-0.05	-0.07	-0.03	0.00	-0.01	-0.03	0.00	0.09	1					
(11) Funded Ratio	-0.12	-0.11	-0.09	-0.01	0.04	-0.02	-0.08	-0.04	-0.04	0.32	1				
(12) % of OS Held	-0.03	-0.08	0.05	0.00	0.01	0.00	-0.02	0.00	0.08	0.12	0.19	1			
(13) Pol. Corr. Conv.	-0.02	0.01	-0.01	0.00	0.01	-0.01	0.00	-0.01	-0.37	0.10	-0.07	-0.05	1		
(14) % Union	-0.02	-0.02	0.01	0.00	0.00	0.00	0.00	0.00	0.10	-0.01	0.23	0.25	-0.25	1	
(15) S&P500	0.05	0.06	0.05	0.00	-0.01	0.00	0.01	0.12	0.00	-0.06	-0.08	0.00	-0.01	-0.01	1

Table 4 - Summary Statistics: Main Variables by Political Proxies

Table 4 reports time-series averages and standard deviations (shown in brackets) of the main variables of analysis. Results are shown for the entire sample (*All Funds*), and for subgroups sorted by the political leaning of funds' members (*Dem. Members* and *Rep. Members*) and by the composition of state government (*Dem. State Gov.* and *Non-Dem. State Gov.*). The unit of observation is the *fund×security×quarter level. Dem. Members* includes all state pension funds headquartered in a state in which the percentage of votes received by the Democratic Party is larger than the percentage of votes received by the Republican Party, based on the latest presidential election results (i.e. for which the Democrat-Dummy equals 1). *Rep. Members* comprises all state pension funds headquartered in a state in which the percentage of votes received by the Democratic Party is not larger than the percentage of votes received by the Republican Party (i.e. for which the democrat-Dummy equals 0). State pension funds in the *Dem. State Gov.* subgroup are headquartered in a state for which the state government is predominantly affiliated to the Democratic-Party (i.e. for which the Dem. State Gov.-Dummy equals 1). *Non-Dem. State Gov.* comprises pension funds for which the majority of the state government is not affiliated to the Democratic-Party, i.e. either Republican, affiliated to another party or nonpartisan (i.e. for which the Dem. State Gov.-Dummy equals 0). Further details on the variable definition and construction can be found in Appendix A.

	All Funds	**Dem. Members**	**Rep. Members**	**Dem. State Gov.**	**Non-Dem. State Gov.**
Portfolio Weight in S&P500 (w_{ijt})	0.23	0.22	0.24	0.22	0.23
	(0.481)	(0.445)	(0.538)	(0.443)	(0.497)
% of Votes for Democratic Party	0.50	0.54	0.44	0.53	0.49
	(0.068)	(0.046)	(0.041)	(0.069)	(0.064)
Democrat-Dummy	0.64	1.00	0.00	0.80	0.57
	(0.480)	(0.000)	(0.000)	(0.401)	(0.496)
% of Dem. State Gov.	0.42	0.51	0.26	0.87	0.21
	(0.362)	(0.351)	(0.321)	(0.125)	(0.213)
Dem. State Gov.-Dummy	0.32	0.40	0.18	1.00	0.00
	(0.465)	(0.489)	(0.382)	(0.000)	(0.000)
KLD Net Score	0.51	0.63	0.32	0.54	0.50
	(3.551)	(3.636)	(3.386)	(3.759)	(3.450)
Log Market Capitalisation	16.17	16.17	16.18	16.20	16.16
	(1.161)	(1.161)	(1.161)	(1.130)	(1.174)
Log Book-to-Market Value	-0.97	-0.95	-1.00	-0.94	-0.98
	(0.801)	(0.801)	(0.800)	(0.805)	(0.799)
Lagged Dividend Yield	0.02	0.02	0.02	0.02	0.02
	(0.036)	(0.038)	(0.033)	(0.041)	(0.033)
Lagged Debt Ratio	0.25	0.25	0.25	0.25	0.25
	(0.173)	(0.172)	(0.173)	(0.175)	(0.172)
Lagged Return on Assets	0.05	0.05	0.05	0.05	0.05
	(0.101)	(0.096)	(0.109)	(0.096)	(0.103)
Lagged Beta Coefficient	1.09	1.10	1.09	1.13	1.08
	(0.720)	(0.694)	(0.763)	(0.693)	(0.731)
Lagged Log Security Return	0.01	0.01	0.01	0.01	0.01
	(0.195)	(0.197)	(0.190)	(0.202)	(0.191)
Log Fund Size	18.14	18.23	17.99	18.18	18.12
	(1.815)	(1.425)	(2.338)	(2.103)	(1.661)
% invested in Equities	56.81	55.13	59.86	54.79	57.78
	(8.829)	(9.287)	(6.957)	(8.548)	(8.798)
Funded Ratio	88.39	89.13	87.14	84.30	90.38
	(16.017)	(16.230)	(15.570)	(18.023)	(14.537)
% of Share Outstanding Held	0.18	0.22	0.11	0.17	0.19
	(0.386)	(0.454)	(0.195)	(0.303)	(0.419)
Political Corruption Convictions	0.35	0.31	0.41	0.35	0.35
	(0.195)	(0.167)	(0.221)	(0.226)	(0.178)
% Union Members	40.00	49.48	23.17	43.35	38.45
	(19.579)	(16.731)	(11.150)	(19.926)	(19.219)
S&P500 Return	0.02	0.02	0.01	0.02	0.02
	(0.106)	(0.111)	(0.096)	(0.116)	(0.101)

Table 5 – Residual Portfolio-Weighted Mean KLD Scores

Table 5 reports time-series averages of quarterly cross-sectional means for the KLD Net score and the seven KLD subcategory scores, for the entire sample (*All Funds*) of state pension funds and for subgroup of pension funds sorted by the political leaning of their members (*Dem. Members* and *Rep. Members*) and by the composition of the state government (*Dem. State Gov.* and *Non- Dem. State Gov.*). Subgroups are defined in Table 5. The table reports residual portfolio-weighted KLD scores. Residual KLD scores are generated by regression a fund's unadjusted portfolio-weighted KLD score per quarter, weighted by the portfolio weight held in each stock, on the mean log market capitalisation and the mean log book-to-market ratio of the fund's holdings during the same quarter, i.e. $portf.-weighted\ mean\ KLD_{jt} = \beta_0 + \beta_1 Mean\ Log\ Market\ Cap._{jt} + \beta_2 Mean\ BM_{jt} + \epsilon_{jt}$. The residual KLD score represents the residual from this regression (ϵ_{jt}). *Dem. – Rep. Members* is the difference between the average KLD scores of the *Dem. Members* and *Rep. Members* subgroups and *Dem. – Non-Dem.* is the difference between the average KLD scores of the *Dem. State Gov.* and *Non- Dem. State Gov.* subgroups; *t*-statistics are reported in brackets against a two-sided alternative. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

	Dem. Members	Rep. Members	Dem. - Rep. Members	Dem. State Gov.	Non-Dem. State Gov.	Dem. – Non-Dem.
Residual KLD Net	0.102	-0.168	**0.271***** (3.644)	-0.136	0.057	**-0.194**** (-2.449)
Residual Corp. Gov. Net	0.032	-0.053	**0.085***** (4.788)	-0.013	0.005	**-0.019** (-0.974)
Residual Com. Net	0.004	-0.007	**0.011** (1.065)	-0.051	0.022	**-0.073***** (-6.549)
Residual Div. Net	0.011	-0.017	**0.028** (1.280)	0.016	-0.007	**0.022** (0.955)
Residual Emp. Net	-0.004	0.007	**-0.012** (-0.431)	-0.040	0.017	**-0.057*** (1.972)
Residual Env. Net	0.043	-0.071	**0.114***** (3.366)	-0.023	0.010	**-0.033** (-0.913)
Residual Hum. Net	0.005	-0.008	**0.129** (1.179)	-0.007	0.003	**-0.010** (-1.108)
Residual Pro. Net	0.012	-0.019	**0.031**** (2.295)	-0.017	0.007	**-0.025*** (-1.744)

Table 6 – Baseline Regression: Regression of Portfolio Weights on Political Leaning and Political Pressures

Table 6 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the company's KLD score as well as an interaction of the company's KLD score and proxies for (1) the political leaning of fund's members ($Democrat - Dummy_{jt}$) and (2) the pressures by state politicians ($Dem.State\ Gov. - Dummy_{jt}$). Specification (1) estimates the following regression equation:$w_{ijt} = \beta_{0,ijt} + \beta_1 KLD_{it-1} + \beta_2 KLD_{it-1} \times Democrat - Dummy_{jt} + \beta_3' company\ controls_{it} + \beta_4' fund\ controls_{jt} + \beta_5 market\ control_t + v_{ij} + u_{ijt}$. In specification (2) we replace the $Democrat - Dummy_{jt}$ with the $Dem.State\ Gov. - Dummy_{jt}$. Specifications (3) estimates the following regression equation:$w_{ijt} = \beta_{0,ijt} + \beta_1 KLD_{it-1} + \beta_2 KLD_{it-1} \times Republican\&NonDemstategov_{jt} + \beta_3 KLD_{it-1} \times Republican\&Demstategov_{jt} + \beta_4 KLD_{it-1} \times Democrat\&Demstategov_{jt} + \beta_5' company\ controls_{it} + \beta_6' fund\ controls_{jt} + \beta_7 market\ control_t + v_{ij} + u_{ijt}$. The *KLD Net* score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The *KLD Net* score in the interaction terms in specification (3) is scaled to have a minimum of 0 and a maximum of 1. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10%, 5% and 1% levels, respectively.

	(1) Pol. Leaning	(2) Pol. Pressure	(3) Pol. Leaning & Pol. Pressure
KLD Net	-0.00673***	-0.00530***	-0.00411***
	(0.000585)	(0.000526)	(0.000542)
Democrat-Dummy × KLD Net	0.00213***		
	(0.000334)		
Dem. State Gov.-Dummy× KLD Net		0.000825***	
		(0.000169)	
Republican&NonDemstategov × KLD Net			-0.0548***
			(0.0117)
Republican&Demstategov × KLD Net			-0.0494***
			(0.0115)
Democrat&Demstategov × KLD Net			0.0228***
			(0.00540)
Market Capitalisation	0.169***	0.169***	0.170***
	(0.00583)	(0.00583)	(0.00583)
Lagged Book-to-Market Value	-0.00856***	-0.00873***	-0.00866***
	(0.00245)	(0.00244)	(0.00244)
Lagged Dividend Yield	0.0586***	0.0586***	0.0574***
	(0.0155)	(0.0155)	(0.0155)
Lagged Debt Ratio	-0.0493***	-0.0494***	-0.0501***
	(0.0122)	(0.0122)	(0.0122)
Lagged Return on Assets	-0.0100	-0.00921	-0.00988
	(0.00735)	(0.00731)	(0.00733)
Lagged Beta	-0.00990***	-0.00978***	-0.00994***
	(0.00211)	(0.00211)	(0.00211)
Lagged Return	-0.0304***	-0.0304***	-0.0304***
	(0.00268)	(0.00268)	(0.00268)
Fund Size	-0.106***	-0.114***	-0.112***
	(0.00916)	(0.00930)	(0.00935)
% invested in Equities	-0.00182***	-0.00225***	-0.00186***
	(0.000218)	(0.000208)	(0.000217)
Actuarial Funded Ratio	0.000829***	0.000799***	0.000822***
	(0.000112)	(0.000111)	(0.000112)
% of Shares Outstanding Held by Fund	0.0985**	0.0986**	0.0985**
	(0.0404)	(0.0403)	(0.0403)
Political Corruption Convictions	0.0238***	0.0215**	0.0210**
	(0.00882)	(0.00897)	(0.00895)
% Union Members	0.00207***	0.00155***	0.00188***
	(0.000386)	(0.000397)	(0.000397)
S&P500 Return	-0.105***	-0.105***	-0.105***
	(0.00445)	(0.00445)	(0.00449)
Constant	-0.588***	-0.392**	-0.477***
	(0.176)	(0.177)	(0.180)
Pension Fund- Security Fixed Effects (FE)	YES	YES	YES
R-squared	0.145	0.145	0.146
Observations	481,909	481,909	481,909
Number of Panel Clusters	18,622	18,622	18,622

Table 7 – KLD Subcategories

Table 7 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the subcategories of the KLD score as well as an interaction of the subcategory score and proxies for (a) the political leaning of the funds' members, $Democrat - Dummy_{jt}$ (Panel A) and (b) the composition of the state government, $Dem.State\ Gov. - Dummy_{jt}$ (Panel B). The 7 KLD subcategories comprise corporate governance, community, diversity, employee relations, environmental record, human rights and product quality. Detailed description on variable definitions and constructions can be found in Appendix A. The KLD Subcategory Net scores are scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively. In order not to drastically reduce the number of observations we have excluded the pension fund controls *% invested in Equities* and *Actuarial Funded Ratio* from this set of regressions. However, our main results are unchanged when including all pension fund controls.

Panel A: Political Leaning	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Corp. Gov. Net	-0.0132***						
	(0.00170)						
Democrat × Corp. Gov. Net	0.00713***						
	(0.000998)						
Community Net		-0.0170***					
		(0.00255)					
Democrat ×Com. Net		0.00784***					
		(0.00176)					
Diversity Net			-0.00180				
			(0.00145)				
Democrat × Div. Net			0.00544***				
			(0.00100)				
Employee Rel. Net				-0.00668***			
				(0.00107)			
Democrat × Emp. Net.				0.00491***			
				(0.000921)			
Environment Net					-0.0165***		
					(0.00136)		
Democrat × Env. Net					0.00524***		
					(0.000773)		
Human Rights Net						-0.0389***	
						(0.00452)	
Democrat × Hum. Net						0.00866***	
						(0.00129)	
Product Quality Net							-0.0187***
							(0.00298)
Democrat × Prod. Net							0.00715***
							(0.000996)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES
Observations	481,909	481,909	481,909	481,909	481,909	481,909	481,909
R-squared	0.143	0.143	0.143	0.142	0.145	0.145	0.144
Number of Panel Clusters	18,622	18,622	18,622	18,622	18,622	18,622	18,622

Table 7 – continued

Panel B: Political Pressures	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Corp. Gov. Net	-0.00898***						
	(0.00156)						
Dem. State Gov. × Corp. Gov. Net	0.00312***						
	(0.000502)						
Community Net		-0.0126***					
		(0.00225)					
Dem. State Gov. ×Com. Net		0.00349***					
		(0.000906)					
Diversity Net			0.00104				
			(0.00136)				
Dem. State Gov. × Div. Net			0.00189***				
			(0.000537)				
Employee Rel. Net				-0.00402***			
				(0.000897)			
Dem. State Gov. × Emp. Net.				0.00238***			
				(0.000479)			
Environment Net					-0.0128***		
					(0.00123)		
Dem. State Gov. × Env. Net					0.00198***		
					(0.000384)		
Human Rights Net						-0.0337***	
						(0.00445)	
Dem. State Gov. × Hum. Net						0.00400***	
						(0.000616)	
Product Quality Net							-0.0146***
							(0.00293)
Dem. State Gov. × Prod. Net							0.00338***
							(0.000457)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES
Observations	481,909	481,909	481,909	481,909	481,909	481,909	481,909
R-squared	0.142	0.143	0.142	0.142	0.144	0.144	0.144
Number of Panel Clusters	18,622	18,622	18,622	18,622	18,622	18,622	18,622

Table 8 – Change in Political Leaning

Table 8 reports changes in the average residual portfolio weighted KLD scores around changes in the political leaning of the state. Panel A presents results on KLD Net Scores, while Panel B and C focus on changes in Strength and Concern scores, respectively. In order to arrive at the figures, for each election cycle, i.e. the four years between presidential elections, we calculate the average residual portfolio weighted KLD Net, Strength and Concern score for each pension fund. If a pension fund does not have holdings data over the entire election cycle, we calculate the average based on the maximum number of quarter available. We then take the difference between the average scores before and after an election for pension funds that (a) had a change in political leaning from Republican to Democratic [6 pension funds]; (b) had a change in political leaning from Democratic to Republican [8 pension funds]; (c) did not experience a change in political leaning, i.e. remained Democratic or Republican leaning [68]; (d) remained Democratic [42]; and (e) remained Republican [26]. The numbers in brackets behind the descriptions in column one indicate the number of occurrences in our sample. For the KLD Net score (Columns (2) – (4)), we report the pre-election average residual portfolio-weighted KLD scores per subgroup (*Pre*), the post-election average residual portfolio-weighted KLD scores per subgroup (*Post*) and the difference between post- and pre-election values along with *t*-statistics in brackets (*Diff.*). For the seven KLD subcategories, we only report differences between post- and pre-election values to preserve space.

Panel A: Residual KLD Net Scores

Residual Mean Scores	**KLD Net**			**C. Gov.**	**Com.**	**Div.**	**Emp.**	**Env.**	**Hum.**	**Pro.**
	Pre	**Post**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**
From Rep. to Dem. (6)	-0.939	-0.433	**0.506*****	0.200***	-0.216***	-0.034	-0.011	0.543***	0.014***	0.009
			(15.767)	(13.742)	(-24.195)	(-1.922)	(-1.295)	(105.018)	(5.851)	(0.781)
From Dem. to Rep. (8)	0.369	-0.573	**-0.942*****	-0.228***	-0.123**	0.060	-0.037	-0.392***	-0.084***	-0.140***
			(-6.537)	(-7.670)	(-3.180)	(1.673)	(-0.884)	(-8.166)	(-7.403)	(-6.245)
No Change - All (68)	-0.322	0.310	**0.632*****	0.133***	0.063***	-0.163***	0.201***	0.180**	0.079***	0.140***
			(3.104)	(3.008)	(2.266)	(-3.165)	(3.094)	(2.624)	(3.347)	(3.501)
No Change - Dem. (42)	-0.417	0.475	**0.892*****	0.189***	0.082***	-0.209***	0.247***	0.283***	0.110***	0.190***
			(3.201)	(3.179)	(2.067)	(-3.470)	(3.053)	(3.098)	(3.426)	(3.598)
No Change - Rep. (26)	-0.168	0.044	**0.212**	0.042	0.033	-0.089	0.126	0.012	0.027	0.060
			(0.783)	(0.683)	(0.940)	(-0.956)	(1.161)	(0.125)	(0.889)	(1.023)

Panel B: Residual KLD Strengths Scores

Residual Mean Scores	**KLD Str.**			**C. Gov.**	**Com.**	**Div.**	**Emp.**	**Env.**	**Hum.**	**Pro.**
	Pre	**Post**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**
From Rep. to Dem. (6)	-0.469	0.487	**0.956*****	0.280***	-0.154***	-0.037*	0.066	0.697***	0.036***	0.035***
			(22.447)	(29.531)	(-20.537)	(-2.412)	(1.996)	(57.307)	(28.311)	(9.644)
From Dem. to Rep. (8)	0.202	-0.552	**-0.754*****	-0.129***	-0.058***	0.125***	-0.010***	-0.499***	-0.058***	-0.035***
			(-6.002)	(-5.570)	(-1.929)	(3.884)	(-4.868)	(-8.359)	(-9.561)	(-2.184)
No Change - All (68)	-0.013	-0.006	**0.007**	-0.034	-0.034**	-0.183***	0.149***	0.049	0.032***	0.029**
			(0.079)	(-1.602)	(-2.034)	(-3.119)	(3.391)	(0.836)	(2.823)	(2.450)
No Change - Dem. (42)	0.039	0.102	**0.063**	-0.035	-0.050***	-0.237***	0.177***	0.118	0.047***	0.043***
			(0.547)	(-1.230)	(-2.721)	(-3.437)	(3.271)	(1.514)	(3.002)	(2.963)
No Change - Rep. (26)	-0.096	-0.179	**-0.083**	-0.033	-0.006	-0.096	0.103	-0.063	0.008	0.005
			(-0.551)	(-1.014)	(-0.206)	(-0.910)	(1.378)	(-0.748)	(0.521)	(0.264)

Panel C: Residual KLD Concern Scores

Residual Mean Scores	**KLD Con.**			**C. Gov.**	**Com.**	**Div.**	**Emp.**	**Env.**	**Hum.**	**Pro.**
	Pre	**Post**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**	**Diff.**
From Rep. to Dem. (6)	0.469	0.919	**0.450*****	0.080***	0.062***	-0.003	0.109***	0.154***	0.023***	0.026**
			(16.110)	(9.131)	(17.731)	(-0.663)	(15.072)	(19.584)	(7.847)	(2.753)
From Dem. to Rep. (8)	-0.168	0.021	**0.188****	0.098**	0.065***	0.065***	-0.063	-0.106***	0.025**	0.105**
			(3.253)	(3.331)	(5.554)	(5.284)	(-1.808)	(-4.112)	(3.260)	(3.419)
No Change - All (68)	0.295	-0.363	**-0.657*****	-0.175***	-0.103***	-0.024**	-0.053*	-0.137***	-0.049***	-0.117***
			(-3.596)	(-3.349)	(-3.563)	(-2.496)	(-1.939)	(-4.363)	(-3.732)	(-3.881)
No Change - Dem. (42)	0.456	-0.373	**-0.829*****	-0.223***	-0.132	-0.028**	-0.070*	-0.165***	-0.063***	-0.147***
			(-3.460)	(-3.226)	(-3.528)	(-2.586)	(-1.991)	(-3.936)	(-3.541)	(-3.712)
No Change - Rep. (26)	0.034	-0.347	**-0.381**	-0.096	-0.055	-0.016	-0.026	-0.092*	-0.026	-0.070
			(-1.370)	(-1.242)	(-1.247)	(-0.917)	(0.280)	(-1.992)	(-1.394)	(-1.518)

Table 9 – Introduction of the PRI

Table 9 reports estimated coefficients from Sub-sample Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the company's KLD score as well as an interaction of the company's KLD score and proxies for (1) the political leaning of the funds' members ($Democrat - Dummy_{jt}$); (2) the composition of the state government ($Dem.State\ Gov. - Dummy_{jt}$); and (3) dummy variables conditioned on both the members' political leaning and the composition of the state government. In Panel A, the sample runs from 1997Q1 to 2004Q4. In Panel B, the sample period comprises 2005Q1 to 2013Q4. Detailed description on variable definitions and constructions can be found in Appendix A. The *KLD Net* score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. In specifications (3) and (6), the *KLD Net score* is scaled to have a minimum of 0 and a maximum of 1. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Panel A: 1997Q1 – 2004Q4	*(1)* w_{ijt}	*(2)* w_{ijt}	*(3)* w_{ijt}
KLD Net	-0.00161	-0.00172	-0.00131
	(0.00148)	(0.00150)	(0.00149)
Democrat-Dummy × KLD Net	0.00000638		
	(0.000468)		
Dem. State Gov.-Dummy× KLD Net		0.000580**	
		(0.000242)	
Republican&NonDemstategov × KLD Net			0.00800
			(0.0188)
Republican&Demstategov × KLD Net			0.0157
			(0.0135)
Democrat&Demstategov × KLD Net			0.0209**
			(0.00849)
Pen. Fund X Security FE	YES	YES	YES
Company Controls	YES	YES	YES
Pension Fund Controls	YES	YES	YES
Market Control	YES	YES	YES
Observations	196,586	196,586	196,586
R-squared	0.127	0.127	0.127
Number of Panel Clusters	11,986	11,986	11,986
Panel B: 2005Q1 – 2013Q4	*(4)* w_{ijt}	*(5)* w_{ijt}	*(6)* w_{ijt}
KLD Net	-0.00507***	-0.00412***	-0.00265***
	(0.000536)	(0.000441)	(0.000431)
Democrat-Dummy × KLD Net	0.00164***		
	(0.000381)		
Dem. State Gov.-Dummy× KLD Net		0.000987***	
		(0.000187)	
Republican&NonDemstategov × KLD Net			-0.0423***
			(0.0129)
Republican&Demstategov × KLD Net			-0.0274*
			(0.0149)
Democrat&Demstategov × KLD Net			0.0310***
			(0.00601)
Pen. Fund X Security FE	YES	YES	YES
Company Controls	YES	YES	YES
Pension Fund Controls	NO	NO	NO
Market Control	YES	YES	YES
Observations	285,323	285,323	285,323
R-squared	0.142	0.142	0.142
Number of Panel Clusters	15,012	15,012	15,012

Table 10: Performance Analysis – Portfolio Building Approach

Table 10 reports results from the monthly time-series regressions applying a calendar time portfolio approach with quarterly rebalancing (based on the new quarterly holdings weights), expressed in equation (3). The dependent variable is the monthly value-weighted portfolio return for portfolios sorted by deviations from benchmark weights and ESG performance (see portfolio details in first three columns, (A)-(I)) and sorted by political proxies ((2)-(5)), where the weight is based on the dollar value of the firm's holding in a fund. The construction of the portfolios is described in section 6.1. Panel A reports alpha coefficients and their corresponding *t*-values based on a Fama-French three factor model plus Carhart's (1997) momentum factor. Panel B reports alpha coefficients and corresponding *t*-values based on a three-level factor model that adds an (orthogonalised) global market factor, (orthogonalised) global size, value and momentum factors, and (orthogonalised) industry factors to the standard four factor model employed in Panel A. All additional factors are orthogonalised against the S&P500 market factor. Details on the three-level factor model can be found in section 6.1. Only alpha estimates are displayed; factor loadings on the additional factors are omitted. The regressions are estimated over the sample period 1997Q1 to 2013Q4. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

			(1) All Funds		(2) Dem. Members		(3) Rep. Members		(2) - (3)		(4) Dem. State Gov.		(5) Non-Dem. State Gov.		(4) - (5)	
Panel A: Fama-French Four Factor Model																
	Dev. S&P500	**KLD**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**
(A) All	-	-	0.0000817	0.54	0.0000910	0.62	0.000181	0.78	-0.000172	-0.90	0.000484**	2.37	0.0000360	0.20	0.000448**	2.56
(B)	Over	-	-0.000128	-0.29	-0.000518	-1.19	-0.00000238	0.00	-0.000515	-0.54	0.000764	1.20	0.0000453	0.06	0.000719	0.67
(C)	Under	-	-0.000126	-0.29	-0.000272	-0.58	0.000597	0.44	-0.000869	-0.53	-0.000568	-0.98	0.000740	0.57	-0.00131	-0.82
(D)	-	High	0.000151	0.19	0.0000418	0.05	-0.000444	-0.47	0.000486	0.35	0.000602	0.76	-0.000174	-0.30	0.000776	0.71
(E)	-	Low	0.000712	0.56	0.000691	0.54	0.000655	1.08	0.0000356	0.02	0.000891	0.70	0.000161	0.31	0.000729	0.47
(F)	Over	High	-0.000862	-0.98	-0.0014	-1.55	-0.000872	-0.71	-0.000617	-0.55	0.000808	0.73	-0.00127	-1.31	0.00208**	2.27
(G)	Under	Low	0.000975	0.72	0.000639	0.47	0.000796	0.52	-0.000156	-0.18	0.00184	1.23	0.000965	0.68	0.000875	0.86
(H)	Over	Low	0.000476	0.34	0.000444	0.32	0.0000422	0.02	0.000402	0.35	0.000356	0.23	0.000575	0.39	-0.000219	-0.24
(I)	Under	High	-0.000112	-0.10	0.0000197	0.02	0.000215	0.16	-0.000196	-0.23	-0.00107	-0.86	0.000397	0.33	-0.00146*	-1.92
(B) - (C)			-0.00000178	0.00	-0.000246	-0.30	-0.000599	-0.31			0.00133	1.24	-0.000695	-0.36		
(D) - (E)			-0.000561	-0.29	-0.000649	-0.33	-0.00110	-0.79			-0.000288	-0.15	-0.000335	-0.33		
(F) - (G)			-0.00134	-0.70	-0.00193	-0.97	-0.000914	-0.42			0.000452	0.22	-0.00185	-0.93		
(H) - (I)			0.00109	0.50	0.000620	0.28	0.000581	0.24			0.00291	1.28	0.000568	0.25		

Table 10 - continued

			(1) All Funds		(2) Dem. Members		(3) Rep. Members		(2) - (3)		(4) Dem. State Gov.		(5) Non-Dem. State Gov.		(4) - (5)	
Panel B: 3-Level Fama-French Four Factor Model																
	Dev. S&P500	**KLD**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**	**Alpha**	***t*-value**
(A) All	-	-	-0.000552***	-3.15	-0.000537***	-3.36	-0.000682**	-2.49	0.000145	0.64	-0.000277	-1.12	-0.000578**	-2.56	0.000301	1.43
(B)	Over	-	-0.00180***	-3.27	-0.00168***	-3.26	0.000586	0.76	-0.00227**	-2.51	-0.000555	-0.79	0.00102	1.43	-0.00158	-1.53
(C)	Under	-	0.00126**	2.55	0.00108**	2.05	-0.00118	-0.98	0.00226	1.63	0.000552	0.86	-0.00115	-0.95	0.00332***	3.25
(D)	-	High	0.00120*	1.68	0.00123*	1.66	-0.00346***	-3.01	0.00469***	3.50	0.00118	1.58	-0.00215***	-2.95	0.00171	1.27
(E)	-	Low	-0.000923	-0.80	-0.00106	-0.90	0.00192***	2.73	-0.00298**	-2.04	-0.000398	-0.35	0.00165***	2.93	-0.00205	-1.51
(F)	Over	High	-0.00149	-1.57	-0.00167	-1.62	-0.00261*	-1.86	0.000934	0.73	-0.000634	-0.51	-0.00210*	-1.83	0.00146	1.26
(G)	Under	Low	0.000183	0.12	-0.000245	-0.16	0.000751	0.38	-0.000996	-0.82	0.000933	0.49	0.000236	0.14	0.000696	0.54
(H)	Over	Low	-0.00138	-1.16	-0.00117	-0.89	-0.00318*	-1.89	0.00200	1.35	0.0000535	0.03	-0.00170	-1.30	0.00176	1.50
(I)	Under	High	0.00271***	2.63	0.00286***	2.70	0.00209	1.58	0.000769	0.72	0.00166	1.43	0.00292**	2.58	-0.00126	-1.33
(B) - (C)			-0.00306***	-3.19	-0.00276***	-2.95	0.00177	1.11			-0.00111	-0.96	0.00218	1.35		
(D) - (E)			0.00212	1.33	0.00228	1.40	-0.00538***	-3.20			0.00158	1.02	-0.00380***	-3.19		
(F) - (H)			-0.000113	-0.07	-0.000499	-0.29	0.000571	0.29			-0.000688	-0.34	-0.000391	-0.23		
(G) - (I)			-0.00253	-1.20	-0.00311	-1.54	-0.00134	-0.52			-0.000729	-0.33	-0.00268	-1.22		

Table 11: Multivariate Performance Analysis

Table 11 reports estimated coefficients from the panel regressions of the quarterly portfolio-weighted fund return on the fund's portfolio-weighted quarterly KLD score, an interaction of the fund's KLD score and one of the political proxies, as well as pension fund and state specific control variables, expressed in equation (4). Detailed descriptions on the construction of the variables are provided in Appendix A. Table D.5 shows summary statics and a correlation matrix for the alternative political proxies. The KLD Net score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. Specifications (1), (4), (7), (9), (11) and (13) contain fund fixed effects. Specifications (2) and (5) contain quarter fixed effects. Specifications (3), (6), (8), (10), (12) and (14) include both fund and quarter fixed effects. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Panel A	(1)	(2)	(3)	(4)	(5)	(6)
Portf.-weighted KLD Net Score	0.00886**	0.00764**	0.00894*	0.00592**	0.00694**	0.00761
	(0.00331)	(0.00371)	(0.00481)	(0.00208)	(0.00345)	(0.00456)
Democrat-Dummy	-0.000215	0.000924	0.00186			
	(0.00504)	(0.000886)	(0.00138)			
Democrat-Dummy × Portf.-weighted KLD Net	-0.00424	-0.000634	-0.000900			
	(0.00328)	(0.000444)	(0.000593)			
Dem. State Gov.-Dummy				-0.00216	0.00144*	-0.0003283
				(0.00755)	(0.000837)	(0.000585)
Dem. State Gov.-Dummy × Portf.-weighted KLD Net				-0.00165	-0.000239	-0.0000882
				(0.00340)	(0.000286)	(0.000281)
% invested in Equities	-0.000471	0.0000702	0.0000154	-0.000338	0.0000751	0.0000408
	(0.000355)	(0.0000584)	(0.0000486)	(0.000379)	(0.0000564)	(0.000047)
Political Corruption Convictions	-0.00737	0.00288	0.00179	-0.00334	0.00262	0.00254
	(0.0172)	(0.00205)	(0.00389)	(0.0176)	(0.00201)	(0.00411)
Actuarial Funded Ratio	-0.00106***	0.0000208	0.000198*	-0.00108***	0.0000259	0.000199
	(0.000347)	(0.0000342)	(0.000111)	(0.000349)	(0.000036)	(0.000124)
Fund Size	-0.106***	0.000183	-0.0105**	-0.103***	0.000178	-0.0103**
	(0.0175)	(0.000152)	(0.00369)	(0.0178)	(0.000157)	(0.00427)
% Union Members	-0.000444	-0.0000325*	0.000146	-0.000143	-0.0000297*	0.000157
	(0.000828)	(0.0000189)	(0.000109)	(0.000932)	(0.0000174)	(0.000131)
Constant	3.074***	1.139***	1.306***	3.000***	1.139***	1.302***
	(0.349)	(0.00689)	(0.0639)	(0.353)	(0.00709)	(0.0710)
Fund Fixed Effects	YES	NO	YES	YES	NO	YES
Quarter Fixed Effects	NO	YES	YES	NO	YES	YES
Observations	991	991	991	991	991	991
R-squared	0.046	0.991	0.991	0.046	0.991	0.991

Table 11 - continued

Panel B	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Portf.-weighted KLD Net Score	0.00624***	0.00796	0.00534**	0.00762	0.00538***	0.00802*	0.00503***	0.00767
	(0.00189)	(0.00463)	(0.00203)	(0.00451)	(0.00141)	(0.00444)	(0.00152)	(0.00444)
Democrat&Demstategov	0.00366	-0.000233						
	(0.00724)	(0.000872)						
Democrat&Demstategov × Portf.-weighted KLD Net	-0.00272	-0.000453						
	(0.00333)	(0.000324)						
Democrat&NonDemstategov			-0.00248	0.00154*				
			(0.00787)	(0.000847)				
Democrat&NonDemstategov × Portf.-weighted KLD Net			0.000205	-0.000237				
			(0.00353)	(0.000276)				
Republican&Demstategov					-0.0226	0.000388		
					(0.0151)	(0.00213)		
Republican&Demstategov × Portf.-weighted KLD Net					0.00133	0.00124*		
					(0.00314)	(0.000623)		
Republican&NonDemstategov							0.00837	-0.00204**
							(0.00769)	(0.000928)
Republican&NonDemstategov × Portf.-weighted KLD Net							0.00819	0.000204
							(0.00617)	(0.000635)
% invested in Equities	-0.000321	0.0000435	-0.000386	0.0000323	-0.000252	0.00000294	-0.000515	0.0000207
	(0.000365)	(0.0000493)	(0.000331)	(0.0000439)	(0.000345)	(0.0000629)	(0.000390)	(0.0000476)
Political Corruption Convictions	-0.00548	0.00253	-0.00581	0.00240	-0.00165	0.00168	-0.00193	0.00177
	(0.0167)	(0.00406)	(0.0175)	(0.00414)	(0.0195)	(0.00407)	(0.0191)	(0.00366)
Actuarial Funded Ratio	-0.00106***	0.000198	-0.00107***	0.000224*	-0.00110***	0.000191	-0.00112***	0.000205*
	(0.000340)	(0.000130)	(0.000342)	(0.000121)	(0.000367)	(0.000118)	(0.000380)	(0.000111)
Fund Size	-0.105***	-0.00968*	-0.107***	-0.0125***	-0.103***	-0.00868*	-0.105***	-0.0108***
	(0.0176)	(0.00483)	(0.0174)	(0.00404)	(0.0187)	(0.00418)	(0.0174)	(0.00364)
% Union Members	-0.000189	0.000172	-0.000346	0.000177	-0.000222	0.000110	-0.000423	0.000164
	(0.000885)	(0.000136)	(0.000905)	(0.000140)	(0.000841)	(0.000112)	(0.000838)	(0.000113)
Constant	3.044***	1.290***	3.089***	1.338***	3.006***	1.278***	3.066***	1.312***
	(0.351)	(0.0806)	(0.346)	(0.0669)	(0.371)	(0.0719)	(0.349)	(0.0621)
Fund Fixed Effects	YES	YES	YES	YES	YES	YES	YES	YES
Quarter Fixed Effects	NO	YES	NO	YES	NO	YES	NO	YES
Observations	991	991	991	991	991	991	991	991
R-squared	0.046	0.991	0.046	0.991	0.048	0.991	0.048	0.991

Table 12 – Portfolio Weight Adjustments

Table 12 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company on the company's KLD score as well as an interaction of the company's KLD score and proxies for (a) the political leaning of the funds' members ($Democrat - Dummy_{jt}$); (b) the composition of the state government ($Dem.State\ Gov. - Dummy_{jt}$); and (c) dummy variables conditioned on both the members' political leaning and the composition of the state government. In Panel A, the portfolio weights are adjusted for industry weights ($ind. - adj. w_{ijt}$). In panel B, the portfolio weights represent deviations of the fund's weight held in a company from the weight that the company has in the S&P500 index. Specifications (4), (6) and (8) use the absolute deviation from the S&P500 portfolio weight as dependent variable ($abs. dev. w_{ijt}$). Specifications (5), (7) and (9) employ the relative deviations from the S&P500 weights ($rel. dev. w_{ijt}$). Detailed description on variable definitions and constructions can be found in Appendix A. The KLD Net score is scaled to have an overall minimum of 0. The KLD Net score in the interaction terms in specifications (3), (8) and (9) is scaled to have a minimum of 0 and a maximum of 1. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Panel A: Industry Adjustments	(1) $w_{ijt}^{ind.}$	(2) $w_{ijt}^{ind.}$	(3) $w_{ijt}^{ind.}$
KLD Net	-0.0333***	-0.0324***	-0.0226***
	(0.00599)	(0.00596)	(0.00631)
Democrat-Dummy × KLD Net	0.0170***		
	(0.00465)		
Dem. State Gov.-Dummy× KLD Net		0.00672***	
		(0.00244)	
Republican&NonDemstategov × KLD Net			-0.423**
			(0.167)
Republican&Demstategov × KLD Net			-0.406**
			(0.182)
Democrat&Demstategov × KLD Net			0.194**
			(0.0780)
Pension Fund X Security FE	YES	YES	YES
Company Controls	YES	YES	YES
Pension Fund Controls	YES	YES	YES
Market Control	YES	YES	YES
Observations	481,909	481,909	481,909
R-squared	0.063	0.063	0.063
Number of Panel Clusters	18,622	18,622	18,622

Panel B: Deviations from S&P500	(4) Abs. dev.	(5) Rel. dev.	(6) Abs. dev.	(7) Rel. dev.	(8) Abs. dev.	(9) Rel. dev.
KLD Net	-0.000292	0.00579***	0.000858**	0.00797***	0.00128***	0.00695***
	(0.000374)	(0.00212)	(0.000356)	(0.00192)	(0.000361)	(0.00180)
Democrat-Dummy × KLD Net	0.00156***	0.00293**				
	(0.000205)	(0.00127)				
Dem. State Gov.-Dummy× KLD Net			0.000314***	0.000527		
			(0.000108)	(0.000676)		
Republican&NonDemstategov × KLD Net					-0.0518***	-0.198***
					(0.00745)	(0.0430)
Republican&Demstategov × KLD Net					-0.0304***	0.106*
					(0.00772)	(0.0549)
Democrat&Demstategov × KLD Net					0.00199	-0.0577**
					(0.00352)	(0.0227)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES
Observations	481,909	481,909	481,909	481,909	481,909	481,909
R-squared	0.028	0.250	0.027	0.250	0.029	0.250
Panel Clusters	18,622	18,622	18,622	18,622	18,622	18,622

Table 13 – Alternative Political Proxies

Table 13 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the company's KLD score as well as an interaction of the company's KLD score and alternative political proxies. Detailed description on the construction of the alternative proxies can be found in Appendix C while descriptions for all other variables are provided in Appendix A. Table D.5 shows summary statics and a correlation matrix for the alternative political proxies. The KLD Net score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	w_{ijt}	w_{ijt}	w_{ijt}	w_{ijt}	w_{ijt}	w_{ijt}	w_{ijt}
KLD Net	-0.0157***	-0.00558***	-0.00537***	-0.00538***	-0.00400***	-0.00546***	-0.00484***
	(0.00197)	(0.000523)	(0.000522)	(0.000526)	(0.000542)	(0.000519)	(0.000519)
% of Democratic votes × KLD Net	0.0208***						
	(0.00382)						
% of Dem. State Gov. × KLD Net		0.00170***					
		(0.000260)					
Dem. State Treasurer-Dummy × KLD Net			0.00109***				
			(0.000201)				
Dem. Governor × KLD Net				0.00103***			
				(0.000166)			
Republican&Non-Dem. Governor× KLD Net					-0.0530***		
					(0.0118)		
Republican&Dem.Governor × KLD Net					-0.0351***		
					(0.0118)		
Democrat&Dem. Governor× KLD Net					0.0296***		
					(0.00563)		
Dem. State Delegation U.S. Congress × KLD Net						0.00102***	
						(0.000289)	
Republican&Non-Dem. Congress× KLD Net							-0.0617***
							(0.00999)
Republican&Dem.Congress × KLD Net							-0.0345**
							(0.0144)
Democrat&Dem. Congress× KLD Net							0.0149
							(0.00987)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES
Observations	481,909	481,909	481,909	481,909	481,909	481,909	481,909
R-squared	0.145	0.145	0.145	0.145	0.146	0.145	0.146
Number of Panel Clusters	18,622	18,622	18,622	18,622	18,622	18,622	18,622

Table 14 – Regressions on the Extended Dataset

Table 14 reports estimated coefficients from Fixed Effect Panel on the extended data set that comprises all companies for which we have KLD scores available. We regress the portfolio weight held by a pension fund in a specific company on the company's KLD score as well as an interaction of the company's KLD score and proxies for the political leaning of funds' members ($Democrat - Dummy_{jt}$) in specifications (1)/(4); the composition of the state government ($Dem.State\ Gov. - Dummy_{jt}$) in specifications (2)/(5); and dummy variables conditioned on both members' political leaning and the composition of the state government in specifications (3)/(6). In specifications (1)–(3), the dependent variable is the simple portfolio weight held by a pension fund in a specific company with respect to its entire holdings. Specifications (4)–(6) employ the industry adjusted portfolio weights as dependent variable. The construction of these variables follow the same logic as described for the (industry-adjusted) portfolio weights with respect to the S&P500 holdings only that in this case we use the entire holdings for which we have KLD data available. The KLD Net score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The KLD Net score in the interaction term with the dummy variables in specifications (3) and (6) is scaled to have a minimum of 0 and a maximum of 1. In this regression the pension fund controls are excluded and the company controls only comprise the log market capitalisation, the log book-to-market ratio, the dividend yield, the debt ratio, and the percentage of shares outstanding. The market control is included. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund*×*security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	$w_{ijt}{}^{extd}$	$w_{ijt}{}^{extd}$	$w_{ijt}{}^{extd}$	ind.-adj. $w_{ijt}{}^{extd}$	ind.-adj. $w_{ijt}{}^{extd}$	ind.-adj. $w_{ijt}{}^{extd}$
KLD Net	-0.00426***	-0.00339***	-0.00398***	-0.0284***	-0.0224***	-0.0265***
	(0.000389)	(0.000377)	(0.000382)	(0.00464)	(0.00478)	(0.00451)
Democrat-Dummy × KLD Net	0.000998***			0.00724***		
	(0.000136)			(0.00184)		
Dem. State Gov.-Dummy× KLD Net		-0.0000832			0.000265	
		(0.0000859)			(0.00121)	
Republican&NonDemstategov			-0.0241***			-0.167***
× KLD Net			(0.00427)			(0.0589)
Republican&Demstategov			-0.0703***			-0.473***
× KLD Net			(0.00836)			(0.136)
Democrat&Demstategov			-0.00187			0.0136
× KLD Net			(0.00272)			(0.0389)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES
Pension Fund Controls	NO	NO	NO	NO	NO	NO
Market Control	YES	YES	YES	YES	YES	YES
Observations	1,239,496	1,239,496	1,239,496	1,239,496	1,239,496	1,239,496
R-squared	0.082	0.082	0.083	0.039	0.039	0.040
Number of Panel Clusters	65,324	65,324	65,324	65,324	65,324	65,324

Table 15 – Different KLD Score Adjustments

Table 15 reports estimated coefficients from Fixed Effect Panel regressions using alternative definition of the KLD proxies. We regress the portfolio weight held by a pension fund in a specific company on different versions of the company's KLD score as well as an interaction of the company's KLD score and proxies for the political leaning of funds' members ($Democrat - Dummy_{jt}$) in specifications (1)/(4)/(7);) the composition of the state government, $Dem.State\ Gov. - Dummy_{jt}$in specifications (2)/(5)/(8); and dummies conditioning on both, members' political leaning and the composition of the state government (3)/(6)/(9). In specifications (1)–(3), we use the KLD Net score without the subcategories corporate governance, human rights and product quality as the proxy for a company's ESG performance. Specifications (4)–(6) employ the Net KLD score based on all 7 subcategories but only use a subsample period from 1997Q1 to 2008Q4, i.e. before KLD changed its methodology to calculate the KLD scores. In specifications (7) – (9), we use a Z-score of the KLD rating. For this we calculate a Z-Score for each year separately so that each year the KLD Net score has a minimum of 0 and a standard deviation of 1. The different KLD scores are scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The KLD scores in the interaction terms in specifications (3)/(6)/(9) are scaled to have a minimum of 0 and a maximum of 1. All specifications exclude the controls *% invested in Equities* and *Actuarial Funded Ratio*. Except for specifications (4)-(6), the sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	KLD excl Corp. Gov., Hum & Pro.	**KLD excl Corp. Gov., Hum & Pro.**	**KLD excl Corp. Gov., Hum & Pro.**	**1997Q1 – 2008Q4**	**1997Q1 – 2008Q4**	**1997Q1 – 2008Q4**	**Z-Score of KLD**	**Z-Score of KLD**	**Z-Score of KLD**
KLD Net	-0.00643***	-0.00492***	-0.00552***	-0.00396***	-0.00310***	-0.00494***	-0.00528***	-0.00438***	-0.00647***
	(0.000725)	(0.000655)	(0.000856)	(0.00102)	(0.00102)	(0.00109)	(0.000706)	(0.000684)	(0.000801)
Democrat-Dummy × KLD Net	0.00235***			0.00105***			0.00162***		
	(0.000441)			(0.000315)			(0.000254)		
Dem. State Gov.-Dummy× KLD Net		0.000900***			-0.000540**			0.000742***	
		(0.000227)			(0.000213)			(0.000127)	
Republican&NonDemstategov × KLD Net			-0.0497***			-0.0329***			-0.0388***
			(0.0134)			(0.0111)			(0.00878)
Republican&Demstategov × KLD Net			-0.0520***			-0.0507***			-0.0352***
			(0.0132)			(0.0116)			(0.00801)
Democrat&Demstategov × KLD Net			0.0231***			-0.0173**			0.0209***
			(0.00629)			(0.00750)			(0.00404)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES	YES	YES
Observations	481,909	481,909	481,909	325,281	325,281	325,281	481,909	481,909	481,909
R-squared	0.144	0.143	0.144	0.143	0.143	0.143	0.144	0.143	0.144
Number of Panel Clusters	18,622	18,622	18,622	14,915	14,915	14,915	18,622	18,622	18,622

Figure 1 – Aggregated Portfolio Holdings of State pension funds

Figure 1 illustrates the aggregated value of the portfolio holdings of all state pension fund in our sample for which there is holdings data available for the respective quarter. Values are reported in billion USD. Total Holdings represent the pension funds' aggregated portfolio value of their entire public equity holdings (solid line). S&P500 Holdings represents the aggregated portfolio value that the public pension plans hold in S&P500 companies (dashed line). All KLD Holdings is the aggregated portfolio value of all state pension funds' holdings which could be merged with KLD data (dotted line). In 2001, the lines for All KLD Holdings and S&P500 diverge as KLD steadily increased their company coverage to comprise all companies included in the Russell 3000 Index.

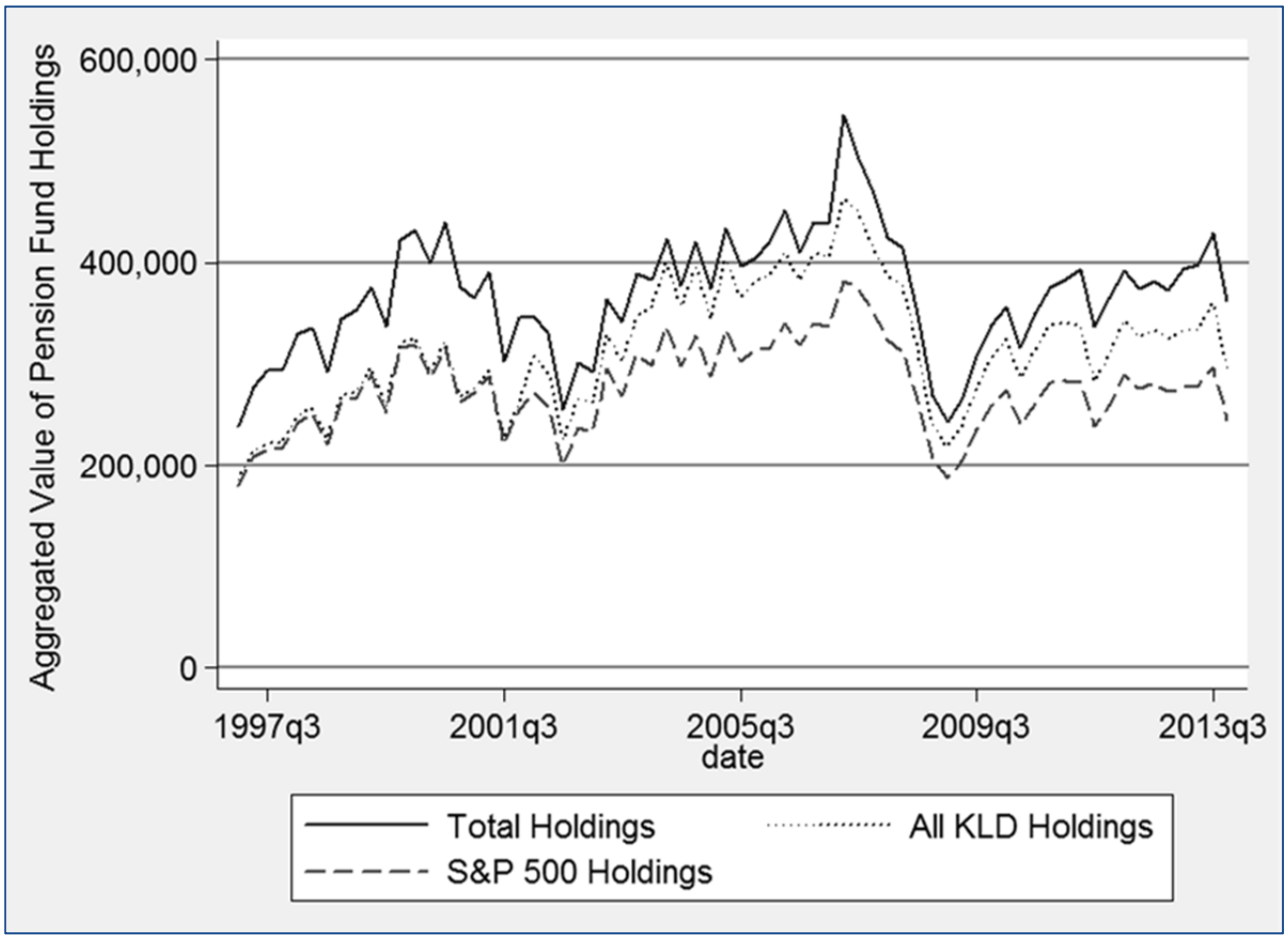
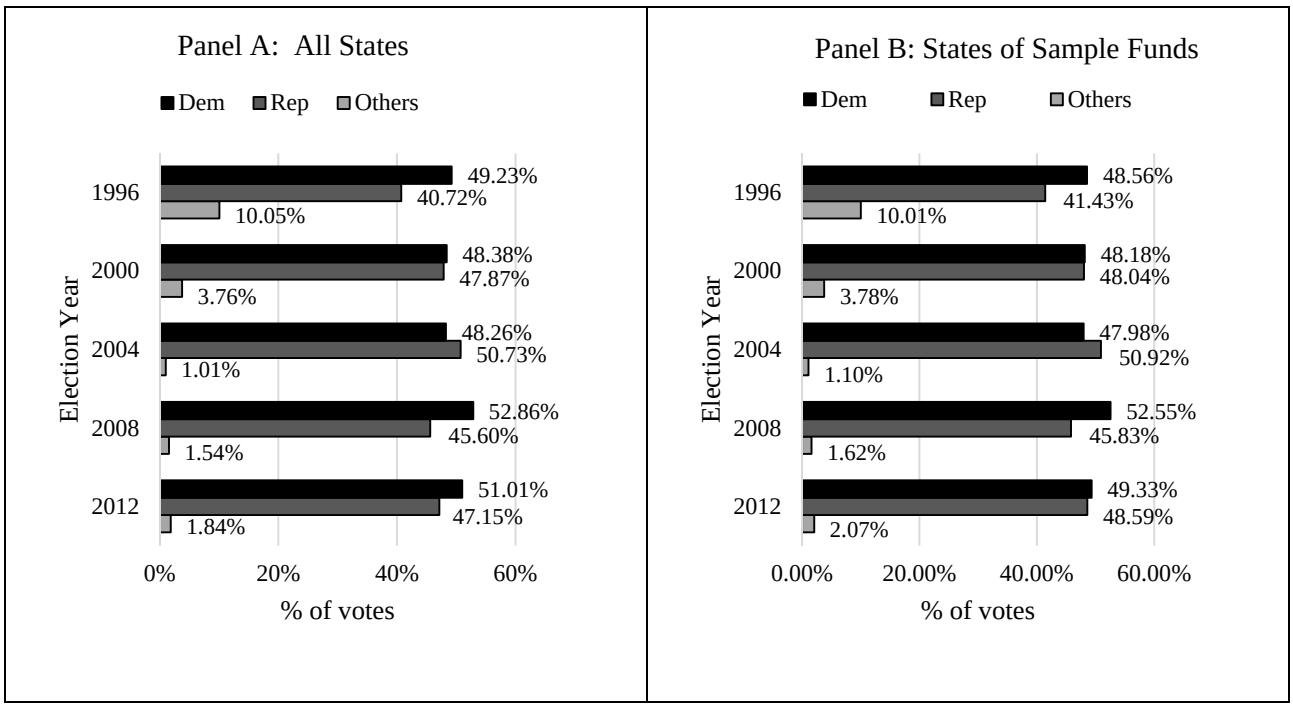


Figure 2 – Presidential Election Results by Year

Figure 2 illustrates the results of the presidential elections for the time period 1996 to 2012, by year and by political party. Panel A shows the distribution of election results by party based on all U.S. states. Panel B only shows the distribution of election results based on the states that are part of our pension fund sample during the particular election period. *Dem* represents votes received by the Democratic Party. *Rep* stands for votes received by the Republican Party. *Others* captures votes to any other party.



Appendix A: Variable Description and Data Sources

Variable	Description	Data Source
DEPENDENT VARIABLES – Portfolio weights		
portfolio weight (w_{ijt})	Portfolio weight of a S&P500 company in a fund's portfolio relative to the fund's total holdings in S&P500 companies; calculated as: $w_{ijt} = \frac{val_{ijt}}{\sum_i^N val_{ijt}}$, i.e. value of a S&P500 company in the portfolio of a fund at the end of a quarter (val_{ijt}) divided by the value of the fund's total holdings in S&P500 companies at the end of the quarter ($\sum_i^N val_{ijt}$)	Thomson Ownership Holdings Database, CRSP
industry-adjusted portfolio weight ($ind.-adj.w_{ijt}$)	Industry-adjusted portfolio weight; calculated as: $ind.-adj.w_{ijt} = \frac{val_{ijt}}{\sum_i^N val_{ijt}^{ind.}}$, i.e. the value of a S&P500 company in the portfolio of a fund at the end of a quarter (val_{ijt}) divided by the value of the fund's total holdings in the industry that the company operates in at the end of the quarter ($\sum_i^N val_{ijt}^{ind.}$); industries are defined according to the 10 Fama-French sectors	Thomson Ownership Holdings Database, CRSP, Kenneth French Data Library
absolute deviation from the S&P500 weight ($abs.dev.w_{ijt}$)	Absolute deviation from the S&P500 weight; calculated as: $abs.dev.w_{ijt} = w_{ijt} - w_{it}^{S\&P500}$, i.e. the portfolio weight of a company in a fund's portfolio (w_{ijt}) minus the weight of the company in the S&P500 index at the end of the quarter ($w_{it}^{S\&P500}$). A value of zero indicates that the pension fund holds the company in exactly the same weight as it is represented in the S&P500; a negative (positive) value indicates an under- (over-) weighting of the stock with respective to the S&P500.	Thomson Ownership Holdings Database, CRSP
relative deviation from the S&P500 weight ($rel.dev.w_{ijt}$)	Relative Deviation from the S&P500 weight; calculated as: $rel.dev.w_{ijt} = \frac{w_{ijt}}{w_{it}^{S\&P500}}$, i.e. the portfolio weight of a company in a fund's portfolio (w_{ijt}) divided by the weight of the company in the S&P500 index ($w_{it}^{S\&P500}$) at the end of the quarter. A value of one indicates that the pension fund holds the company in exactly the same weight as it is represented in the S&P500; a value lower (greater) than one indicates an under- (over-)weighting of the stock with respective to the S&P500.	Thomson Ownership Holdings Database, CRSP
portfolio weight based on the extended dataset ($w_{ijt}{}^{extd}$)	Portfolio weight of a company in a fund relative to the fund's total holdings in companies with available KLD ratings; calculated as: $w_{ijt}{}^{extd} = \frac{val_{ijt}}{\sum_i^N val_{ijt}{}^{extd}}$, i.e. value of company *i* in the portfolio of fund *j* (val_{ijt}) divided by the value of the fund's total holdings in companies with available KLD data at the end of quarter *t* ($\sum_i^N val_{ijt}{}^{extd}$)	Thomson Ownership Holdings Database, CRSP
industry-adjusted portfolio weight based on the extended dataset ($ind.-adj.w_{ijt}{}^{extd}$)	Industry-adjusted portfolio weights; calculated as: $ind.-adj.w_{ijt}{}^{extd} = \frac{val_{ijt}}{\sum_i^N val_{ijt}^{ind.,extd}}$, i.e. value of company *i* in the portfolio of fund *j* at the end of a quarter *t* (val_{ijt}) divided by the value of the fund's total holdings in the industry that the company operates in for the extended dataset at the end of the quarter ($\sum_i^N val_{ijt}^{ind.,extd}$); industries are defined according to the 10 Fama-French sectors	Thomson Ownership Holdings Database, CRSP, Kenneth French Data Library
MAIN INDEPENDENT VARIABLES		
Environmental, Social, Governance Performance – KLD Scores		
KLD Net Score	Overall KLD Net Score; i.e. the sum of all net scores for the 7 KLD subcategories described below: $KLD\ Net = Corp.Gov.Net + Com.Net + Div.Net + Emp.Net + Env.Net + Hum.Net + Pro.Net$ We scale the KLD Net score to have an overall minimum of zero (unless otherwise indicated) in order to facilitate the interpretation of the coefficient estimates on the interaction terms of the KLD scores and the political proxies. The same applies for all KLD Subcategory scores.	KLD via WRDS
Corporate Governance Net Score (*Corp. Gov. Net*)	Corporate Governance Net Score; i.e. the sum of all Corporate Governance Strength items minus the sum of all Corporate Governance Concern items: $Corp.Gov.Net = Corp.Gov.Strengths - Corp.Gov.Concerns$	

Community Net Score (*Com. Net*)	Community Net Score; i.e. the sum of all Community Strength items minus the sum of all Community Concern items: $Com.Net = Com.Strengths - Com.Concerns$	KLD via WRDS
Diversity Net Score (*Div. Net*)	Diversity Net Score; i.e. the sum of all Diversity Strength items minus the sum of all Diversity Concern items: $Div.Net = Div.Strengths - Div.Concerns$	
Employee Relations Net Score (*Emp. Net*)	Employee Relations Net Score; i.e. the sum of all Employee Relations Strength items minus the sum of all Employee Relations Concern items: $Emp.Net = Emp.Strengths - Emp.Concerns$	
Environmental Records Net Score (*Env. Net*)	Environmental Records Net Score; i.e. the sum of all Environmental Records Strength items minus the sum of all Environmental Records Concern items: $Env.Net = Env.Strengths - Env.\ Concerns$	
Human Rights Net Score (*Hum. Net*)	Human Rights Net Score; i.e. the sum of all Human Rights Strength items minus the sum of all Human Rights Concern items: $Hum.Net = Hum.Strengths - Hum.Concerns$	
Product Quality Net Score (*Pro. Net*)	Product Quality Net Score; i.e. the sum of all Product Quality Strength items minus the sum of all Product Quality Concern items: $Pro.Net = Pro.Strengths - Pro.Concerns$	
Proxies for the Political Leaning of Funds' Members		
% of Dem. (Rep.) votes	Percentage of Votes to the Democratic (Republican) Candidate according to the Latest Presidential Elections, per State; updated after every presidential election, i.e. every four years.	Dave Leip's Atlas of U.S. Presidential Elections (uselectionatlas.org)
Democrat-Dummy	Dummy variable equal to one if the percentage of a state's votes received by the Democratic Candidate at the latest Presidential Election is larger than the percentage of votes received by the Republican Party Candidate, i.e. $democrat = 1\ , if\ \ \%\ of\ Dem.votes > \%\ of\ Rep.votes$, and takes a value of zero otherwise.	
Proxies for Political Pressures by State Politicians		
% of Dem. State Gov.	Proportion of a State's Government that is affiliated to the Democratic Party; i.e. *% of Dem. State Gov.= 0.5 ∗ Dem. Governor + 0.25 ∗ Dem. Upper Chamber + 0.25 ∗ Dem. Lower Chamber* ,where *Dem. Governor* is a dummy variable equal to one if the state governor is a Democrat and zero otherwise and *Dem. Lower Chamber* and *Dem. Upper Chamber* are the proportions of the Lower and Upper Chamber of the state government, respectively, that are members of the Democratic Party.	U.S. Census Bureau's National Data Book: Gubernational and State Legislatures; National Governor's Association (nga.org)
Dem. State Gov.-Dummy	Dummy variable equal to one if the majority of a State's Government is affiliated to the Democrat Party, i.e. *Democratic State Government - Dummy* takes the value of one if *% of Democratic State Government* is greater than 50%, and zero otherwise.	
Proxies Conditioned on the Political Leaning of Funds' Members and Political Pressures by State Politicians		
Democrat& Demstategov	Dummy equal to one if the fund has Democratic-leaning members and is from a state with a predominantly Democratic state government, i.e. $Democrat\&Demstategov = 1\ , if\ \ Democrat = 1\ \&\ Dem.State\ Gov. = 1$, and takes a value of zero otherwise.	See above
Democrat& NonDemstategov	Dummy equal to one if the fund has Democratic-leaning members and is from a state with a predominantly Non-Democratic state government, i.e. $Democrat\&NonDemstategov = 1\ , if\ Democrat = 1\ \&\ Dem.State\ Gov. = 0$, and takes a value of zero otherwise.	
Republican& Demstategov	Dummy equal to one if the fund has Republican-leaning members and is from a state with a predominantly Democratic state government, i.e. $Republican\&Demstategov = 1\ , if\ \ Democrat = 0\ \&\ Dem.State\ Gov. = 1$, and takes a value of zero otherwise.	
Republican& NonDemstategov	Dummy equal to one if the fund has Democratic-leaning members and is from a state with a predominantly Democratic state government, i.e. $Republican\&NonDemstategov = 1\ , if\ Democrat = 1\ \&\ Dem.State\ Gov. = 1$, and takes a value of zero otherwise.	

FURTHER CONTROL VARIABLES		
Company-specific Controls		
Log Market Capitalisation	Natural Logarithm of the Stock's Market Capitalisation; i.e. the product of the price per share and the number of shares outstanding, expressed in thousands of dollars.	CRSP
Log Book-to-Market Value	Natural Logarithm of the Book-to-Market Ratio; i.e. the book value of the equity over the market value of equity, measured at the end of the previous quarter and expressed in percentage points. The market value of equity is updated every quarter, while the book equity is based on the last fiscal year ending.	CRSP, Compustat
Dividend Yield	Dividend Yield; i.e. the ratio of dividends per share over the price per share, measured at the end of the previous quarter and expressed in percentage points.	CRSP, Compustat
Debt Ratio	Debt Ratio; i.e. a company's total debt (sum of long-term debt and current debt) over total assets, expressed in percentage points. We use lagged debt ratios, updated based on the last fiscal year ending.	Compustat
Return on Assets	Return on Assets; i.e. ratio of income before extraordinary items divided by total assets. We use lagged return on assets, updated based on the last fiscal year ending.	Compustat
Log Security Return	Natural Logarithm of the Stock's Quarterly Return	CRSP
Lagged Beta Coefficient	Stock Market Beta; i.e. the beta coefficient based on rolling regressions of a stock's monthly excess return on the market risk premium (i.e. the return on the S&P500 index in excess of the risk-free rate) and an intercept, over a 36 months window.	CRSP
Pension Fund and State Controls		
Log Fund Size	Natural Logarithm of a Fund's Actuarial Assets under GASB Standards	CRR Public Plans Database
% invested in Equities	Percentage of a Pension Fund's Assets Invested in Public Equities, updated at the end of every year and expressed in percentage points.	CRR Public Plans Database
Funded Ratio	Pension Fund's Funded Ratio under GASB Standards, i.e. the ratio of the Actuarial Assets under GASB Standards over the Actuarial Liabilities under GASB Standards, measured in percentage points and updated at the end of every year. If the *Funded ratio* is smaller than 100% the pension fund is said to be underfunded.	CRR Public Plans Database, individual Fund's CAFRs
% of Share Outstanding Held	Percentage of Shares Outstanding Held by the Pension Fund, i.e. the ratio of the number of shares held by the pension fund over a company's total number of shares outstanding, expressed in percentage points.	Thomson Ownership Holdings Database, CRSP
Political Corruption Convictions	Ratio of a State's Federal Public Corruption Convictions per Capita, i.e. the number of federal public corruption convictions per state over the state's population, updated at the end of every year. The crimes investigated by the Department of Justice comprise conflicts of interests, fraud, campaign-finance violations and obstruction of justice. Following Glaeser & Saks (2006), we replace observations for which convictions are not reported by the average of the observed number of convictions in a surrounding 5-year period, which is three years before and two years past the missing observation year.	U.S. Department of Justice's Report to Congress on the Activities and Operations of the Public Integrity Section, U.S. Census Bureau
% Union Members	Percentage of a State's Public Employees that are Union Members. Details on the coverage and construction on the database can be found in Hirsch & MacPherson (2003).	Union Membership and Coverage Database by Barry Hirsch (www.unionstats.com)
Market Control		
S&P500 Return	Natural Logarithm of the S&P500 Return Index over the Previous Quarter, i.e. we take the natural logarithm of the monthly return on the S&P Composite Index after adding a value of one and accumulate these monthly log returns over the previous quarter. The variable is expressed in percentage points.	CRSP

Appendix B: Comparison of the CRR Pension Plans with the 31 Sample Plans

Table B.1 (on the next page) provides a comparison of the 126 state and local pension plans in the CRR dataset and the 31 plans included in our sample from 2001 to 2011. The state pension funds in our sample are considerably larger than the average state pension fund, both with respect to their assets under management as well as the number of members. This finding is intuitive as larger funds are more likely to have the resources in order to internally manage their assets as well as to generate economies of scale from internal asset management. Despite the size differences, the funds in our sample share comparable features with the 126 largest U.S. public funds in terms of their funding status, equity allocation, and investment performance: They have a similar average funding level as indicated by their average funded ratio of 84.49 %, compared to 84.28 % for the 126 CRR plans. They allocate on average 56.06% of their assets to equities, compared to 55.23% for the CRR plans and they only slightly underperform the average CRR plan, with a 1-year portfolio return of 5.42 % for the 31 funds in our sample as compared to 5.66 % for the average CRR plan. Additionally, when we look at the geographical coverage of our sample we find that our sample covers states from all parts of the U.S. so that we conclude that there are no major biases with respect to the geographical distribution of our sample.

Table B.1 - Summary Statistics: Comparison of State and Local Pension Plans in the CRR Database and in the Thomson Ownership Database

Table B.1 reports summary statistics for U.S. state and local pension plans, obtained from the Public Plans Database by the Centre for Retirement Research (CRR) at Boston College. Panel A reports values for the 126 public plans in the CRR database. Panel B presents values for the 31 public plans in our sample. *Market Value of Assets* is the value of the plans' assets based on market prices in million USD. *Number of Plan Members* comprises the total number of members of a plan, including active members and beneficiaries. *Actuarial Assets* is the value of actuarial assets under GASB standards, reported in million USD. It will often differ from the market value of assets in a given year because actuarial assets are calculated using techniques that smooth out fluctuations in the level of assets that arise from investment gains and losses. *Actuarial Liabilities* are the actuarial accrued liabilities under GASB standards, reported in million USD. It is equal to the present value of future benefits, discounted using the plan's assumed long term investment return. *Funded Ratio* is equal to the ratio of actuarial assets over actuarial liabilities and represents the funded ratio under GASB standards, reported in percentage points. *Percentage Invested in Equities* is the percentage of total assets that a plan invests in public equities, reported in percentage points. *1-year Investment Return* is the rate of return on the total portfolio over a 1-year investment horizon, reported in percentage points. The data sample comprises the period from 2001 to 2011. For the further analyses, we have complemented the data for the entire period 1997 to 2013 based on plan's individual Comprehensive Annual Financial Reports (CAFR), where available.

	Mean	Std.-Dev.	Median	Min.	Max.	5th Perc.	95th Perc.	N
Panel A: 126 State and Local Pension Plans in CRR Database								
Market Value of Assets (in mio. USD)	18,300	28,200	8,882	180	251,000	1,098	72,900	1,358
Number of Plan Members	178,058	230,290	101,487	3,246	1,631,769	7,493	553,765	1,304
Actuarial Assets (in mio. USD)	19,100	29,100	9,390	235	257,000	1,167	74,400	1,314
Actuarial Liabilities (in mio. USD)	22,400	32,200	12,300	254	308,000	1,359	81,100	1,314
Funded Ratio (in %)	84.28	16.77	85.40	19.10	147.70	54.20	107.34	1,313
Percentage Invested in Equities (in %)	55.23	10.91	57.00	7.11	82.00	36.01	69.67	1,353
1-year Investment Return (in %)	5.66	12.44	9.50	-29.63	36.24	-19.10	21.60	1,362
Panel B: 31 State and Local Pension Plans in the Thomson Ownership Database								
Market Value of Assets (in mio. USD)	47,500	46,100	37,000	3,285	251,000	4,619	144,000	337
Number of Plan Members	410,416	356,887	363,283	27,037	1,631,769	29,911	1,168,849	322
Actuarial Assets (in mio. USD)	48,900	48,600	39,200	2,693	257,000	4,521	154,000	330
Actuarial Liabilities (in mio. USD)	55,300	53,700	42,200	3,675	308,000	4,819	164,000	329
Funded Ratio (in %)	84.49	22.49	87.15	35.60	142.56	57.40	112.10	328
Percentage Invested in Equities (in %)	56.06	9.77	57.35	26.60	74.08	37.40	69.03	336
1-year Investment Return (in %)	5.42	12.75	9.09	-27.15	28.83	-20.43	22.43	340

Appendix C: Alternative Political Proxies

In Section 7.3. we test the robustness of our results to alternative political proxies. In the following we explain the construction and data sources of these new proxies.

Political Leaning of the State Treasurer

Following Wald & Zhang (2015), we collect data on the political affiliation of the state treasurers or the person with similar responsibilities and construct the dummy variable *Dem. State Treasurer–Dummy* that equals one if the state treasurer is a member of the Democratic Party, and zero otherwise. Thus, the alternative category (*Dem. State Treasurer–Dummy* = 0) comprises Republican state treasurers, non-partisan state treasurers and state treasurers of unknown political affiliation. In order to collect information on the political affiliation of the state treasurer, we use various data sources such as the National Association of State Treasuries. Wald & Zhang (2015) point out that the state treasurer in most states is directly involved in the fund's governance, often in his or her position as a trustee to the fund. Arguably, the state treasurer could use this influence to impact the investment decisions of the fund. As such, the political affiliation of the state treasurer can also be regarded as a proxy for the presence of political pressures on funds rather than a pure measure of the state's political leaning.

Political Leaning of the State Governor

In our main measure of composition of the state governor, we include the political leaning of the state governor as one input. However, it might be argued that the state governor as an individual has the largest power in state government institutions and might be able to exercise the greatest pressures on e.g. state pension funds. Thus, we construct a dummy variable that captures the political leaning of the state governor. *Dem. Governor-Dummy* equals one if the state governor is affiliated to the Democratic Party, and zero otherwise. Similar to the *Dem. State Treasure-Dummy*, the alternative category (*Dem. Governor–Dummy* = 0) comprises Republican state governors, non-partisan governors and governors of unknown political affiliation. We also construct dummy variables that condition on both, the political leaning of funds' members and the party affiliation of the state governor: *Democrat&Dem.Governor- Dummy* equals 1 if the funds' members are Democratic leaning and the state governor is affiliated to the Democratic Party (i.e. *Democrat=1* & *Dem.Governor=1*), and 0 otherwise; *Democrat&NonDem.Governor- Dummy* takes the value of 1 if the funds' members are Democratic leaning and the state governor is not affiliated to the Democratic Party (i.e. *Democrat=1* & *Dem.Governor=0*), and 0 otherwise; *Republican&Dem.Governor-Dummy* equals 1 if the funds' members are Republican leaning and the state governor is affiliated to the Democratic Party (i.e. *Democrat=0* & *Dem.Governor=1*), and 0 otherwise; and *Republican&NonDem.Governor-Dummy* takes the value of 1 if the funds' members are Republican and

the state governor is not affiliated to the Democratic Party (i.e. *Democrat=0* & *Dem.Governor=0*), and 0 otherwise.

Composition of the State Delegation to the U.S. Congress

Following Di Guili & Kostovetsky (2014), we calculate the proportion of a State's Delegation to the U.S. Congress that is affiliated to the Democratic Party (*% of Dem. State Delegation*) as:

$$\%\ of\ Dem.\ State\ Delegation = 0.5 * \%\ of\ Dem.\ State\ Senators + 0.5 * \%\ of\ Dem.\ Representatives,$$

where *% of Dem. State Senators* is the proportion of a state's senators that are members of the Democratic Party and *% of Dem. Representatives* is the proportion of members of the State's House of Representatives that are Democrats. We obtain the data on the composition of the U.S. Congress from Charles Stewart III and Jonathan Woon's Congressional Committee Assignment database. In addition, we construct a dummy variable based on the composition of the U.S. Congress (*Dem. State Delegation–Dummy*) that takes the value of one if the congressional delegation is predominantly Democratic, i.e. $\%\ of\ Democratic\ State\ Delegation > 0.5$, and zero otherwise. Again, we construct dummy variables that condition on both, the political leaning of funds' members and the composition of the state delegation to the U.S. Congress: *Democrat&Dem.Congress- Dummy* equals 1 if the funds' members are Democratic leaning and the majority of the state delegation to the U.S. Congress is affiliated to the Democratic Party (i.e. *Democrat=1* & *Dem.State Delegation=1*), and 0 otherwise; *Democrat& Dem.Congress - Dummy* takes the value of 1 if the funds' members are Democratic leaning and majority of the state delegation to the U.S. Congress is not affiliated to the Democratic Party (i.e. *Democrat=1* & *Dem.State Delegation =0*), and 0 otherwise; *Republican&Dem.Congress-Dummy* equals 1 if the funds' members are Republican leaning and the majority of the state delegation to the U.S. Congress is affiliated to the Democratic Party (i.e. *Democrat=0* & *Dem.State Delegation =1*), and 0 otherwise; and *Republican&NonDem.Congress-Dummy* takes the value of 1 if the funds' members are Republican and the majority of the state delegation to the U.S. Congress is not affiliated to the Democratic Party (i.e. *Democrat=0* & *Dem.State Delegation =0*), and 0 otherwise.

Appendix D: Additional Tables

Table D.1 - Baseline Regression on Sub-Periods with Different Portfolio Weight Proxies

Table D.1 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the company's KLD score as well as an interaction of the company's KLD score and proxies for (a) the political leaning of funds' members ($Democrat - Dummy_{jt}$); and (b) the composition of the state government ($Dem.\,State\,Gov. - Dummy_{jt}$). In Panel A, the sample runs from 1997Q1 to 2004Q4. In Panel B, the sample period comprises 2005Q1 to 2013Q4. Specifications (1)/(5)/(9)/(14) employ the simple portfolio weights as dependent variable. Specifications (2)/(6)/(10)/(14) are based on the industry-adjusted version of the portfolio weights. Specifications (3)/(7)/(11)/(15) use the absolute deviation proxy as dependent variable, whereas specifications (5)/(8)/(12)/(16) focus on the relative deviation proxy. Detailed description on variable definitions and constructions can be found in Appendix A. The *KLD Net* score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Panel A: 1997Q1 – 2004Q4	(1) $\boldsymbol{w_{ijt}}$	(2) $w_{ijt}^{ind.}$.	(3) abs. dev.	(4) rel. dev.	(5) $\boldsymbol{w_{ijt}}$	(6) $w_{ijt}^{ind.}$	(7) abs. dev.	(8) rel. dev.
KLD Net	-0.00161	-0.0427**	-0.000166	0.00102	-0.00172	-0.0429*	-6.31e-05	-0.00767*
	(0.00148)	(0.0215)	(0.00123)	(0.00455)	(0.00150)	(0.0221)	(0.00125)	(0.00450)
Democrat × KLD Net	0.00000638	0.00120	0.000300	-0.0127***				
	(0.000468)	(0.00512)	(0.000400)	(0.00263)				
Dem. State Gov. × KLD Net					0.000580**	0.00453*	0.000356*	0.00543***
					(0.000242)	(0.00241)	(0.000183)	(0.00107)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES	YES
Observations	196,586	196,586	196,586	196,586	196,586	196,586	196,586	196,586
R-squared	0.127	0.070	0.030	0.282	0.127	0.070	0.030	0.282
Number of Panel Clusters	11,986	11,986	11,986	11,986	11,986	11,986	11,986	11,986
Panel B: 2005Q1 – 2013Q4	(9) $\boldsymbol{w_{ijt}}$	(10) $w_{ijt}^{ind.}$	(11) abs. dev.	(12) rel. dev.	(13) $\boldsymbol{w_{ijt}}$	(14) $w_{ijt}^{ind.}$.	(15) abs. dev.	(16) rel. dev.
KLD Net	-0.00507***	-0.0260***	-0.0000624	0.0156***	-0.00412***	-0.0199***	0.000294	0.0127***
	(0.000536)	(0.00769)	(0.000349)	(0.00340)	(0.000441)	(0.00530)	(0.000309)	(0.00342)
Democrat × KLD Net	0.00164***	0.0107	0.000420*	-0.00517***				
	(0.000381)	(0.00687)	(0.000219)	(0.00138)				
Dem. State Gov. × KLD Net					0.000987***	0.00685**	-0.000289**	-0.00411***
					(0.000187)	(0.00279)	(0.000125)	(0.000813)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES	YES
Observations	285,323	285,323	285,323	285,323	285,323	285,323	285,323	285,323
R-squared	0.142	0.064	0.085	0.162	0.142	0.064	0.085	0.162
Number of Panel Clusters	15,012	15,012	15,012	15,012	15,012	15,012	15,012	15,012

Table D.2 – Industry Weights and Deviations from the Benchmark Weights

Table D.2 row two presents the average KLD score of the S&P500 companies sorted by the 10 Fama-French sectors. The additional rows report the average weight that a sector has in the S&P500 index in percentage points (*Average Weight in S&P500*), as classified by the 10 Fama-French sectors, and compare it to the average weight that the sector has in the portfolio of each of the 31 U.S. state pension funds in percentage points (*Average Weight held by)*. The last row states the average percentage points that the sector's weight in the pension fund portfolios deviates from the average weight in the S&P500 index (*Deviation of Portfolio Weights from S&P500 Weight*). The 10 Fama-French Sectors are classified as follows:

1 Consumer Non-Durables (Food, Tobacco, Textiles, Apparel, Leather, Toys)
2 Consumer Durables (Cars, TV's, Furniture, Household Appliances)
3 Manufacturing (Machinery, Trucks, Planes, Chemicals, Off Furn, Paper, Commercial Printing)
4 Oil, Gas, and Coal Extraction and Products
5 Business Equipment (Computers, Software, and Electronic Equipment)
6 Telephone and Television Transmission
7 Wholesale, Retail, and Some Services (Laundries, Repair Shops)
8 Healthcare, Medical Equipment, and Drugs
9 Utilities
10 Others (Mines, Construction, Building Material, Transportation, Hotels, Bus Service, Entertainment, Finance)

Fama-French Sector	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Average KLD Score	0.751	0.518	0.441	-2.454	1.793	-0.121	0.195	0.687	-0.468	0.506
Average Weight in S&P500	*6.17*	*3.89*	*11.66*	*8.63*	*18.38*	*5.23*	*8.54*	*11.23*	*3.41*	*23.73*
Average Weight held by:										
AlaskaRMB	6.14	0.24	9.76	4.92	6.00	5.22	5.82	6.40	1.03	88.36
ArizonaSafePERS	5.91	1.73	10.47	8.56	20.53	4.87	13.39	16.34	1.93	24.00
CalPERS	5.59	3.85	11.50	8.81	18.08	5.53	8.59	11.68	3.45	24.02
CalSTRS	5.44	3.81	11.98	8.70	18.23	5.83	8.24	11.68	3.51	23.75
ColoradoPERA	6.54	3.84	11.40	8.91	18.20	5.40	8.33	11.28	3.24	23.61
FloridaSBA	6.09	3.91	11.57	8.53	18.09	5.81	8.09	11.62	3.37	23.89
IllinoisMunRS	5.77	3.56	10.94	7.33	14.47	5.63	8.17	10.91	3.58	29.68
KentuckyRetS	6.42	4.44	11.03	6.99	16.16	5.08	8.69	10.95	2.97	28.08
KentuckyTRS	5.38	3.31	12.43	8.53	17.86	4.95	8.89	11.17	3.48	24.78
LouisianaSERS	6.07	1.18	11.25	9.24	17.95	5.93	7.91	10.99	3.49	25.99
MichiganMunERS	6.21	1.12	12.11	9.29	17.72	5.22	8.19	11.23	3.54	25.44
MichiganTreas	6.23	4.71	12.53	8.24	18.34	3.44	8.38	12.77	2.55	24.23
MontanaInvB	2.26	5.16	8.42	6.40	21.23	6.37	10.48	15.26	1.95	25.25
NYCityERS	5.82	1.13	21.75	7.51	12.69	4.00	7.85	9.15	3.13	27.95
NJInvB	6.48	3.90	11.13	9.12	18.49	4.98	7.89	12.63	3.86	22.84
NYStateComRS	6.25	3.65	11.83	8.72	17.86	5.52	8.09	11.31	3.34	24.39
NYStateTRS	6.18	3.78	11.89	9.25	16.70	5.96	7.76	10.66	3.95	24.86
NewMexicoERB	5.70	3.68	11.02	8.46	17.29	5.29	7.66	10.82	3.24	28.01
OhioPERS	6.47	3.65	11.51	8.62	17.72	6.01	7.94	11.39	3.38	24.43
OhioTRS	6.12	3.69	11.97	8.65	18.40	5.52	7.94	11.88	3.31	23.63
OregonPERS	6.45	0.97	12.61	11.13	17.65	4.89	8.65	10.94	4.02	22.85
PennsylvaniaPSERS	5.54	3.00	11.58	10.83	17.08	4.80	7.89	11.30	3.69	25.03
SouthDakotaInvB	5.11	6.13	11.47	6.24	12.67	6.14	6.77	13.21	3.35	29.37
TennesseeConsRS	6.04	5.42	10.18	6.86	20.75	6.67	8.48	12.85	2.76	20.82
TexasERS	6.62	3.56	11.32	8.94	19.26	5.09	7.93	12.34	2.65	23.11
TexasTRS	6.18	1.08	12.25	10.72	18.53	4.34	7.22	11.37	3.52	24.92
UtahRS	6.29	1.04	12.62	10.58	17.86	5.07	8.14	11.17	3.85	24.77
VirginiaRS	6.97	3.78	12.53	8.05	17.06	5.66	8.40	11.62	4.07	23.58
WashingtonStateIB	9.03	0.00	28.08	46.33	0.00	0.00	0.00	0.00	0.00	8.05
WisconsinIB	5.73	3.39	14.45	9.15	18.51	3.90	7.85	15.43	2.36	21.69
Deviation of Portfolio Weights from S&P500 Weight	*-0.14*	*-0.80*	*0.79*	*1.16*	*-1.67*	*-0.13*	*-0.55*	*0.11*	*-0.32*	*2.65*

Table D.3 – Baseline Regression with Industry Fixed Effects

Table D.3 reports estimated coefficients from Fixed Effect Panel regressions of the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the company's KLD score as well as an interaction of the company's KLD score and proxies for (1) the political leaning of funds' members ($Democrat - Dummy_{jt}$); (2) the composition of the state government, ($Dem.State\ Gov. - Dummy_{jt}$); and for (3) dummies are conditioned on both members' political leaning and the composition of the state government. Additionally, each of the four specifications contains industry fixed effects. Detailed description on variable definitions and constructions can be found in Appendix A. The KLD Net score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The KLD Net score in the interaction terms in specifications (3) and (4) is scaled to have a minimum of 0 and a maximum of 1. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

	(1) Pol. Leaning	(2) Pol. Pressure	(3) Pol. Leaning & Pol. Pressure
KLD Net	-0.00667*** (0.000575)	-0.00524*** (0.000516)	-0.00404*** (0.000532)
Democrat-Dummy × KLD Net	0.00214*** (0.000332)		
Dem. State Gov.-Dummy× KLD Net		0.000827*** (0.000168)	
Republican&NonDemstategov × KLD Net			-0.0553*** (0.0116)
Republican&Demstategov × KLD Net			-0.0493*** (0.0114)
Democrat&Demstategov × KLD Net			0.0228*** (0.00535)
Industry FE	**YES**	**YES**	**YES**
Pen. Fund X Security FE	YES	YES	YES
Company Controls	YES	YES	YES
Pension Fund Controls	YES	YES	YES
Market Control	YES	YES	YES
Observations	481,909	481,909	481,909
R-squared	0.150	0.149	0.150
Number of Panel Clusters	18,622	18,622	18,622

Table D.4 – Separate Regressions for each of the 10 Fama-French Sectors

Table D.4 reports estimated coefficients from Fixed Effect Panel regressions for subsets of the data sorted by Fama-French Sectors. We regress the portfolio weight held by a pension fund in a specific company (w_{ijt}) on the companies KLD score as well as an interaction of the company's KLD score and proxies for (1) the political leaning of funds' members, $Democrat - Dummy_{jt}$ (Panel A), and (2) the composition of the state government, $Dem.\,State\,Gov. - Dummy_{jt}$ (Panel B). The regressions have been estimated for each of the 10 Fama-French sectors separately and each of the 10 columns represents the regression results of these industry-specific subsamples. Detailed description on variable definitions and constructions can be found in Appendix A. The KLD Net score is scaled to have an overall minimum of 0 in order to facilitate the interpretation of the interaction term. The sample runs from 1997Q1 to 2013Q4. Standard errors are clustered at the panel variable level, i.e. *fund×security* level. Robust standard errors are shown in brackets. *, **, *** indicate statistical significance at the 10 %, 5 % and 1 % levels, respectively.

Fama French Sector	(1) **Consumer Non-Durables**	(2) **Consumer Durables**	(3) **Manufacturing**	(4) **Oil, Gas, and Coal**	(5) **Business Equipment**	(6) **Tele. and TV Transmission**	(7) **Wholesale, Retail, and Some Services**	(8) **Healthcare, Med. Equip., and Drugs**	(9) **Utilities**	(10) **Others**
Panel A: State's Political Leaning										
KLD Net	0.00402**	-0.00760**	-0.00422***	-0.0115***	-0.0152***	-0.0116***	-0.000875	0.00154	-0.00113**	-0.00513***
	(0.00162)	(0.00382)	(0.000793)	(0.00294)	(0.00196)	(0.00311)	(0.00110)	(0.00198)	(0.000471)	(0.00104)
Democrat-Dummy × KLD Net	0.00108	0.00395**	0.00154***	0.00239	0.00285***	0.0103***	0.00161**	0.00341***	0.000807**	0.00147**
	(0.000728)	(0.00162)	(0.000393)	(0.00216)	(0.00104)	(0.00257)	(0.000688)	(0.00109)	(0.000360)	(0.000649)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Observations	33,534	10,595	74,381	27,187	75,738	13,526	50,884	36,300	35,452	124,312
R-squared	0.138	0.186	0.174	0.219	0.245	0.263	0.202	0.200	0.328	0.187
Panel B: Political Pressures										
KLD Net	0.00495***	-0.00474	-0.00318***	-0.0103***	-0.0135***	-0.00491*	0.000335	0.00408**	-0.000444	-0.00426***
	(0.00146)	(0.00351)	(0.000700)	(0.00283)	(0.00174)	(0.00269)	(0.00102)	(0.00182)	(0.000426)	(0.000955)
Dem. State Gov.-Dummy× KLD Net	-0.0000981	-0.000261	0.000533**	0.00216**	0.00144***	0.00460***	0.000429	0.000667	-7.75e-05	0.000943***
	(0.000361)	(0.000876)	(0.000271)	(0.00102)	(0.000466)	(0.00148)	(0.000305)	(0.000572)	(0.000220)	(0.000341)
Pen. Fund X Security FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Company Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Pension Fund Controls	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Market Control	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES
Observations	33,534	10,595	74,381	27,187	75,738	13,526	50,884	36,300	35,452	124,312
R-squared	0.138	0.182	0.173	0.219	0.245	0.257	0.201	0.198	0.327	0.187

Table D.5 – Summary Statistics and Correlation Matrix: Alternative Political Proxies

Panel A reports summary statistics for the alternative political proxies, as employed in the regression specifications presented in Table 13. Panel B shows a correlation matrix of all political proxies. Further details on the variable definition and construction can be found in Appendix C.

Panel A: Summary Statistics	**Mean**	**Std.-Dev.**	**Median**	**Min.**	**Max.**	**Skewness**	**Kurtosis**	**N**
% of Democratic votes	0.50	0.07	0.51	0.25	0.63	-0.20	2.94	574,151
Democrat-Dummy	0.64	0.48	1.00	0.00	1.00	-0.58	1.34	574,151
% of Democratic State Government	0.42	0.36	0.50	0.00	1.00	0.26	1.71	574,151
Democratic State Government-Dummy	0.32	0.47	0.00	0.00	1.00	0.79	1.62	574,151
Dem. Governor-Dummy	0.40	0.49	0.00	0.00	1.00	0.43	1.18	574,151
% of Dem. State Delegation to U.S. Congress	0.51	0.28	0.50	0.00	1.00	-0.08	1.51	574,151
Democratic State Delegation - Dummy	0.50	0.50	0.00	0.00	1.00	0.02	1.00	574,151
Democratic State Treasurer-Dummy	0.55	0.50	1.00	0.00	1.00	-0.20	1.04	574,151
Panel B: Correlation Matrix	**(1)**	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**
(1) % of Democratic votes	1.00							
(2) Democrat-Dummy	0.76	1.00						
(3) % of Dem. State Government	0.36	0.34	1.00					
(4) Dem. State Government-Dummy	0.25	0.23	0.85	1.00				
(5) Dem. Governor-Dummy	0.19	0.19	0.85	0.84	1.00			
(6) % of Dem. State Deleg. U.S. Congress	0.80	0.71	0.40	0.28	0.17	1.00		
(7) Dem. State Delegation - Dummy	0.71	0.62	0.39	0.29	0.18	0.90	1.00	
(8) Dem. State Treasurer-Dummy	0.37	0.30	0.52	0.37	0.36	0.27	0.23	1.00