Pacific-Basin Finance Journal 21 (2013) 899–913

Contents lists available at SciVerse ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

The price of sin in the Pacific-Basin ☆

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ARTICLE INFO

Article history:
Received 22 August 2011
Accepted 21 June 2012
Available online 30 June 2012

JEL classification:
G12
G15
M14

Keywords:
Asset pricing
Behavioral finance
Corporate financial policy
Socially responsible investment
Social norms
Groupthink

ABSTRACT

Hong and Kacperczyk (2009) argue that social norms *against* sin stocks influence investor behavior and corporate financial policies. This paper examines "sin" stocks in seven Pacific-Basin markets that exhibit a variety of social norms: Australia, India, Japan, South Korea, Malaysia, New Zealand and Singapore. In doing so, we provide further evidence on the pricing of sin stocks. Consideration of measurable cultural differences between the markets suggests the price of sin is a manifestation of groupthink.

1. Introduction

Hong and Kacperczyk (2009) (HK) argue that social norms – where the utility of actions is determined by the belief and actions of others (Akerlof, 1980) – drive both investor behavior and corporate financial policies.

☆ We have benefited from comments made by delegates to the 2011 Finance and Corporate Governance held in Melbourne and 2011 Asian Finance Association Conference held in Macau SAR, China. Paul LiJian Tan gratefully acknowledges the financial support of the University of Western Australia Business School Honours Research Scholarship. We also would like to thank the anonymous reviewer and the editor, Jun-Koo Kang, for their valuable comments. We are responsible for any remaining errors.

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0927-538X/$ – see front matter
doi:10.1016/j.pacfin.2012.06.005

Focusing on American "sin" stocks (publicly traded firms involved in alcohol, tobacco or gaming) they find that these (sin) stocks form a lower proportion of the portfolios of "norm-constrained" institutions.[1] HK find that sin stocks are relatively undervalued and that they have higher risk-adjusted returns *ceteris paribus*. HK explore an interesting corollary to their finding that sin stocks are shunned by norm-constrained institutions. They consider if the financial policies of norm-constrained institutions might be associated with sin stocks facing increased difficulty in tapping equity markets. HK find evidence that sin stocks are more likely to rely on debt financing: debt markets are less open to public scrutiny than equity markets and it is therefore less difficult for sin stocks to borrow than to issue equity.[2]

It may be that the pressure of social norms is felt particularly keenly by investors in the US market. HK suggest that social norms might also influence investors outside the US. While their US analysis considers a broad range of variables which might be influenced by social norms, HK *only* extended their study to the *returns* of sin stocks in a number of countries: Canada, France, Germany, Italy, Netherlands, Spain, Switzerland and the UK. Due to the relatively low number of sin stocks available to them,[3] they group the stocks from these countries into one portfolio. They find that the returns of this portfolio of sin stocks are also higher than other stocks, *ceteris paribus*. These countries are all Western countries with much in common with the US. If social norms influence investment, then we might expect to find the results reported in HK also apply to markets and cultures which are broadly similar to the US. For example, in the Pacific-Basin, we might expect investors' attitudes to sin stocks in Australia and New Zealand to be much the same as what HK observe in the US. We do not know if HK's findings apply to markets and cultures which are different from the US.

In this paper, we replicate and extend HK's analysis in seven Pacific-Basin markets: Australia, India, Japan, South Korea, Malaysia, New Zealand and Singapore. HK's findings and hypotheses are built around the notion of social norms. We find results broadly in keeping with HK in the markets which we suspect are culturally akin to the US: Australia and New Zealand. When HK's approach is applied to other markets, however, we find different, but *prima facie* systematic, responses to sin stocks. These different responses are consistent with social norms driving investor behavior. The differences we find are consistent with different social norms pertaining in the countries which are culturally different to the US. Further, our findings appear to be related to measurable cultural factors; this allows us to make some suggestions about the pricing of sin stocks in the markets we examine. We reconcile the differences between the markets we examine to those examined in HK by suggesting that price of sin is a manifestation of groupthink.

The social-norms hypothesis in HK implies that moral constraints will drive investors toward certain behavior. That is, investors herd. It may be serendipitous that American investors, and investors from cultures similar to America's, herd toward virtuous investment behavior consistent with American social norms. In HK, the herding is driven by individual investors putting pressure on professional money managers. Professional money managers, however, also appear to be influenced by their personal values. Hong and Kostovetsky (2012) demonstrate that political biases of fund managers affect their allocation of the funds they manage to "sin" stocks.

Social norms, as articulated in HK, imply pressure to conform to society's notions of virtue; a society's values and norms are an aspect of its culture. The *Oxford English Dictionary* defines culture as "the distinctive ideas, customs, social behavior, products, or way of life of a particular society, people, or period. Hence: a society or group characterized by such customs."[4] Work in Finance, however, has utilized the notion that culture involves transferral of something; for example, "…culture is defined as transmission from one generation to the next, via teaching and imitation, of knowledge, values, and other factors that influence

[1] HK show that sell-side analysts respond to this lower institutional demand. As there is less demand for the analysis of sin stocks by institutions, sin stocks attract lower analyst coverage than other comparable firms (O'Brien and Bhushan, 1990). HK's finding regarding analyst coverage may be regarded as a corollary to their analysis and, as such, we do not report these findings for the Pacific-Basin markets we study in this paper. However, we have conducted this analysis and it is available on request from the corresponding author.

[2] Recognizing comments made to us that the original analysis in HK is parenthetical, we do not report our analyses for the Pacific-Basin markets we study in this paper. However, it is available on request from the corresponding author. Sin stocks in Japan, South Korea and Malaysia have higher cash levels, hence do not rely on debt financing. In New Zealand, sin stocks have lower cash levels, and rely more on debt financing.

[3] See Hong and Kacperczyk (2009) Table 6, Panel A, page 34.

[4] "culture, n.". OED Online. December 2011. Oxford University Press. Accessed 23 February 2012.