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INVESTING IN “SIN” COMPANIES

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Investors will overlook social norms on "sin" companies when financial incentives are substantial

When Philip Morris – the company that makes Marlboro cigarettes – was considering leaving the tobacco business altogether in the 1990s, it was operating in a strongly anti-tobacco environment: the company was viewed as evil and selling a lethal product[i], and institutional investors such Harvard University and City University of New York were divesting their portfolio of tobacco stock. Given that Philip Morris was perceived to be “primarily a stock for professional or institutional investors”[ii], it was particularly worrying.

“Companies who make their money in the ‘sin’ industries such as the tobacco, alcohol and gaming industries typically receive less attention from institutional investors and financial analysts,” says **Liu Yanju**, Assistant Professor of Accounting at Singapore Management University (SMU). In a research paper in collaboration with Lu Hai of the University of Toronto and Kevin Veenstra of McMaster University, Liu also found that “social norms and attitudes towards these types of businesses are subject to compromise when their stock performances well”.

In other words: money talks.

Investing in “sin” companies: Money talks

“We found that institutional shareholdings and analysts' coverage of sin firms were low when firm performance was low but went up with rising performance expectations,” Liu says. “That suggests that market participants may ignore social norms and standards with the right financial reward. This finding adds to the current debate on why there could be a gap between the investment practices of Wall Street and the ethical standards of Main Street.”

Liu and her research colleagues measured ethical standards, or social norms, regarding the acceptability of “sin” industries by using the consumption of their products as a proxy. Looking at the case of Philip Morris, tobacco consumption in the U.S. – Liu used U.S. data for the research – should be on a downward trend to reflect the low social acceptability of tobacco companies; that has indeed been the case, with per capita consumption (pieces of tobacco) falling from nearly 3000 in 1980 to below 1500 in 2007.

"Market participants may ignore social norms and standards with the right financial reward."

Liu then ran calculations to combine such consumption data with sin companies' expected financial performance to predict institutional ownership i.e. the proportion of a company's stock that is owned by institutional investors. For tobacco companies expected to deliver poor financial performance, that figure is just over 20 percent. For tobacco companies expected perform well financially, it rises to nearly 25 percent.

However, Liu's calculations predict that if tobacco companies were to be socially acceptable, institutional ownership would jump to nearly 40 percent if expected financial performance was good. Even if expected profits were less than impressive, institutional ownership would still be above 35 percent. It begged the question: If institutional ownership is important, is it possible to do branding and marketing to improve the public's impression of tobacco companies?

The value of image

That perhaps explains the fortunes of Philip Morris, which renamed itself as Altria in 2003 to distance the company from negative image that is associated with its former name. The company eventually decided to keep its tobacco business, and it has since moved into the wine business when it bought UST Inc., a moist smokeless tobacco manufacturer that owned Ste Michelle Wine Estates, a wine company.

"It's not so simple to generalise that once management does some promotion, it will increase the acceptance of sin products," Liu says. "You need to take in consideration governments' view of such products. For example, packaging on cigarette is required to warn of the dangers of smoking."

The crackdown on tobacco advertising and the publicising of smoking's cancer links are the main contributors to the habit's unrelenting fall in acceptance level. Meanwhile, alcohol has seen a slight pickup in consumption – and in the context of Liu's research, social acceptance level – since the late 1990's. Liu attributes part of the increase in alcohol intake to medical advances, where "some of the diseases that are associated with drinking used to be incurable but now they are curable".

What about gambling? Gaming consumption, which was measured as the number of people who visited Las Vegas casinos as a percentage of total U.S. population, has been rising steadily for three decades – five percent in 1980, about 13 percent in 2007. Gaming companies' financial performance have gone up and down through the years, but it appears that more and more people are gambling, in casinos or otherwise.

"For gambling, the data we used reflects the number of people who visited Las Vegas, but these days, plenty of people do online gambling," Liu explains. "People's attitudes towards gambling may have changed over time because of technology advances which make it easier to gamble."

The more people gamble, the more revenue gets generated by gaming companies. When those revenues become too attractive, investors will ignore social norms - because the house always wins.