

# Form of the government and Investment Sensitivity to Stock Price

## Abstract

One of the important functions of the stock market is to produce information through stock prices. Specifically, stock market aggregates information from different market participants and incorporate it into stock prices. Previous studies have documented that stock prices even have some private information that managers don't have. Chen, Goldstein and Jaing (2007) find evidence that firm managers notice this private information and use stock price to guide their investment decisions. They find a strong positive relationship between a firm's investment expenditures and its market value. Recent studies in political finance find evidence that divided government (gridlock) creates more uncertainty in the stock market relative to the unified government (harmony). Given the higher uncertainty caused by the divided government, we conjecture that firm managers will more likely to use the information content of stock prices to guide their investment decision. In other words, we would expect to see a stronger positive relationship between a firm's investment expenditures and its market value during the period of divided government relative to unified government. Using 143,642 firm-year observations from 1952 to 2009 in the United States, we find that investment-to-price sensitivity is two times higher during divided government than during unified government. This finding is still hold to our robustness tests. Our findings show that the government's form (divided versus unified) has a significant impact on managers' investment decisions through the information content of stock prices.

**Key words:** *political uncertainty, divided government, gridlock, investment sensitivity-to-stock price*

**JEL:** G38, P16

## 1. Introduction.

Do managers pay attention to the stock price when they make investment decisions? The answer to this question has two opposing views. Traditional view suggests that stock prices do not provide any additional information to the managers since managers, as insiders, possess all information that is contained in the stock price (Morck, Shleifer, and Vishny, 1990). But, the more recent literature (Durnev, Morck, and Yeung, 2004; Luo, 2005; and Chen, Goldstein and Jaing, 2007) finds that stock price embodies the views of the market participants about the firm so that the managers can improve their investment decisions by observing the stock price of their firm. Chen et al. (2007) concludes that the firm managers learn from the private information in stock price about their own firms' fundamentals and use that knowledge while making investment decisions.

Recent studies in political finance find evidence that divided government (gridlock) creates more uncertainty in the stock market relative to the unified government (harmony). The United States Congress consists of the Senate and the House of Representatives. Both senators and representatives are chosen through direct election. Currently, there are 435 members of the House of Representatives who represent a district and serve a two-year term. House seats are proportionately divided by population among the states. Each state has two senators so there are one hundred senators who serve six-year terms. But, every two year approximately one-third of the Senate is up for election. Thus, the control in house and senate may change every two years. We call the government is *unified* when all three entities: the White house, the House of Representatives and the Senate are under the control of the same party and *divided* when at least one of the House or the Senate is not under the control of the party of the president.

Most studies in political finance attribute higher uncertainty to the divided government. Beyer et al. (2006) found that equity returns tend to be higher and less volatile during periods of political harmony (that is when there is unified instead of divided government). Similarly, Bechet and Fuss (2007) argue that when the government is divided a policy is the result of bargaining among a large set of proposals which makes the predictability of future policies more uncertain. Their data supports the hypothesis that the divided government increases financial risk.<sup>1</sup>

Given the higher uncertainty caused by the divided government, we conjecture that firm managers will more likely to use the information content of stock prices to guide their investment decision during that form of government. In other words, we would expect to see a stronger positive relationship between a firm's investment expenditures and its market value during the period of divided government relative to unified government.

Following Chen (2007) regression model, we compared investment-to-price sensitivity during unified and divided government in the United states from 1952-2009. As predicted, we find that the investments of US firms are more dependent on stock prices during gridlock than during unified government.

Using 143,642 firm-year observations from 1952 to 2009 in the United States, we find that investment-to-price sensitivity is two times higher during divided government than during

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<sup>1</sup> Some other authors do not agree that divided governments make any difference. Arguing in this front, Mayhew (1991), looking at US governments between 1946 and 1990, concludes that it does not seem to make all that much difference whether party control of the American government happens to be unified or divided. Butler [2000] quoted Edward Yardeni, chief investment strategist at Deutsche Banc Securities, "Gridlock has been very good for the stock market." Just one-day prior, in a well-detailed *Wall Street Journal* article by Ip [2000], a review of political influences on the stock market was presented. Ip noted that, "...since 1982, the market has soared while government has been divided for all but two years..."

unified government. This finding still holds to our robustness tests. Our findings show that the government's form (divided versus unified) has a significant impact on managers' investment decisions through the information content of stock prices.

The remainder of this paper is structured as follows: Section 2 describes sample and model. Section 3 discusses the results of the Univariate and multivariate tests and Section 4 concludes.

## **2. Sample and Model.**

### *A. Sample Construction and Descriptive Statistics*

Our sample consists of the all US firms from 1952 to 2009 which have data available in CRSP and COMPUSTAT. We get information on the form of the government (Unified or Divided) from the U.S. government website.

We obtained accounting variables: total asset, capital expenditures, net income, annual stock return, book value of equity, R&D expenses, and depreciation and amortization expenses from COMPUSTAT. We constructed market value of equity from the information on price and number of share outstanding obtained from CRSP. We collected monthly stock returns of the firms also from CRSP and dropped the observation if the return is missing for one of the months. Our final sample comprises 8,023 firms for the period 1952 through 2009, for a total of 143,642 firm-year observations.

[Table 1 about here]

Table 1 presents the distribution of observations based on year and form of the government. Out of 58 years of our sample period, the United States had unified government for

22 years and there was gridlock regime for the remaining 36 years. The table also provides the number of firms for each year in the sample period. The number varies every year for several reasons with the general trend of more firms in later years.

[Table 2 about here]

Panel A of Table 2 provides definition of our main variables: Investment (I) , Firm value (Q) , Cash Flow (CF) , Change in sale( $\Delta$  Sale) ,One over total Asset (1/A) , Return ( $R_{t+1}$ ) , and Divided dummy (D).We also control for the economy at aggregate level by introducing two macro variables: Market Premium (MKT) , and Inflation (INF).

Panel B of Table 2 provides summary statistics for our main variables. The summary statistics include number of observations (N), Minimum value (MIN), Median value (MEDIAN), mean value (MEAN), standard deviation (SD) and the maximum value (MAX).

### *B. Regression Specification*

In order to compute the investment sensitivity to stock price, we run the following baseline regression similar to as described in Chen et al. (2007) and used by others including Durnev (2011) .

$$\begin{aligned}
 I_{i,t} = & \alpha_i + \beta_1 \cdot Divided + \beta_2 \cdot Q_{i,t-1} + \beta_3 \cdot Divided_t * Q_{i,t-1} + \gamma_1 \cdot CF_{i,t-1} \\
 & + \gamma_2 \cdot Divided * CF_{i,t-1} + \lambda_1 \cdot \Delta S_{i,t-1} + \lambda_2 \cdot Divided_t * \Delta S_{i,t-1} + \varphi_1 \cdot \left( \frac{1}{A_{i,t}} \right) \\
 & + \varphi_2 \cdot R_{i,t+1} + \varphi_3 \cdot MKT_{t-1} + \varphi_4 \cdot INF_{t-1} + \epsilon_{i,t}
 \end{aligned} \tag{1}$$

where the subscripts  $i$  and  $t$  represent firms and years respectively and  $\alpha_i$  captures firm fixed effect. Following Peterson (2009), we adjust the regression's standard errors for heteroskedasticity, serial correlation, and cross sectional correlation using two-way clustering at the firm and year levels.

Investment (I) is defined as sum of the capital expenditure and R&D expenses scaled by total assets. Our main explanatory variables are Divided, a dummy variable taking value 1 if the form of the government is divided and 0 if the government is unified, and Firm value (Q) defined as sum of market value of equity and total assets minus book value of equity scaled by total assets. The coefficient  $\beta_2$  measures the investment-to-price sensitivity during the period of unified government (with Divided=0). We are more interested in the variable  $Divided_t * Q_{i,t-1}$  obtained by interacting the Divided dummy and firm value. If divided government increases the investment-to-price sensitivity, then we expect the coefficient  $\beta_3$  to be significantly greater than zero. Interpretation of the coefficients of regression involving interaction terms suggests that the magnitude of  $\beta_2 + \beta_3$  provides the value of investment to price sensitivity during divided government.

Our other control variables are: Cash Flow (CF) defined as sum of the net income and depreciation and amortization expenses scaled by total assets; Change in sale ( $\Delta$  Sale) defined as difference of sale in year  $t$  and year  $t-1$  divided by sale in year  $t-1$ ; One over total Asset (1/A) defined as one divided by total asset; Return ( $R_{t+1}$ ) defined as one year ahead abnormal stock return calculated relative to CRSP value weighted market index. We also control for the economy at aggregate level by introducing two macro variables: Market Premium (MKT) defined as Value weighted stock index minus T-bill; and Inflation (INF) is the inflation in a given year. We include the interaction between cash flow and divided dummy  $Divided * CF$  in

order to see whether the effect of cash flow on investment differs during divided and unified governments.

Similarly, we control for growth in sales,  $\Delta S$ , and its interaction with the Divided dummy  $Divided * \Delta S$  because of the argument that, when market uncertainty is large, managers are more likely to extract information from fundamentals.

We control for Return,  $R$ , as in Drunev (2011) following Baker et al. (2003) which suggest that investment increases when stock is overvalued, and  $R$  can capture company overvaluation due to speculative bubbles.

Finally, we control the probable impact of macro economy by introducing Market Premium (MKT) and Inflation (INF) in the regression.

### 3. Results.

In Table 3, we present the results of the univariate tests. We divide the sample into two groups: Unified and Divided. If an observation belongs to the year in which the form of the government is unified that lies under the Unified subsample where as if an observation belongs to the year in which the form of the government is divided then that lies under the Divided subsample. The result shows that the mean differences for all the variables under consideration are significant at 1% level in the two different forms of governments. Investment (I) , Firm value (Q), Change in sale ( $\Delta$  sale), reciprocal of assets ( $1/A$ ), and market premium (MKT) have significantly larger means during divided government than during unified government where as cash flow (CF), one year ahead return ( $R_{t+1}$ ) and inflation ( INF) have significantly larger means during unified government compared to the divided government.

[Table 3 about here]

These results motivate us to further investigate the role of the form of the government on the financial policies and outcomes.

In Table 4, we present Pearson correlation coefficients of the variables used in the regressions. In this table, we want to see whether the relationship between investment (I) and firm value (Q) during unified and divided governments are different. The table shows that the correlation between investment and firm value is 0.09 during unified government where as the correlation between these two variables is 0.16 during divided government. This signals that the investment and firm value are more related during divided government than during unified government.

[Table 4 about here]

The significantly different mean values of the variables (in Table 3) and almost double correlation coefficient between investment and firm value during divided government than during unified government make our hypothesis, that whether investment-to-price sensitivity differs significantly in two forms of governments, an interesting empirical question.

[Table 5 about here]

Table 5 presents the multivariate regression results. We test our main prediction that investment-to-price sensitivity is higher during divided government using three different specifications of the regression Model 1 in section 2.B. In Table 5, Model 1 is the baseline OLS regression in which we do not control year and firm fixed effect. In this model we see that the



coefficient of the interaction term ( $\beta_3 = 2.90$ ) between firm value and divided dummy is highly significant with ( $p\text{-value} < 0.0001$ ) which indicates that investment is more sensitive to stock prices during divided government. The increase in investment-to-price sensitivity is economically significant. The following discussion shows the economic significance. Consider the period during unified government where Divided dummy is zero. The coefficient of firm value  $\beta_2 = 1.37$ . This shows that a one-standard deviation increase in firm value (.78) is associated with a increase in investment of  $1.37 * .78 = 1.07$ , which is a 9.2 % increase in investment relative to the average investment of 11.47%. But, the increase in investment-to-price sensitivity is much bigger during divided government. The coefficient on the interaction between firm value and divided dummy,  $\beta_3 = 2.90$ , so the investment-to-price sensitivity during divided government is  $\beta_2 + \beta_3 = 3.27$ . So, during divided government, a one standard deviation increase in firm value increases investment by  $(3.27 - 1.07) * .78 = 2.55$ , which is 19.72% higher than the investment increase during unified government period. We also find that the investment –sensitivity to cash flow decreases during divided government as suggested by the significant negative coefficient ( $\gamma_2$ ) of the interaction term between divided dummy and the cash flow.

In Model 2 of Table 5, we run the same regression as in Model 1 but we control for year fixed effect and firm fixed effect. In this case, the coefficients change little bit  $\beta_2 = .87$  and  $\beta_3 = .60$  but they both remain highly significant at with ( $p\text{-value} < 0.0001$ ). All the results remain qualitatively similar as in Model 1.

In the third model of the Table 5, we run the regression as above but in this case we control for the year and firm fixed effect, as well as, we perform two-way clustering in firm and year. The results do not alter qualitatively.

All the above mentioned results suggest that the investment to price sensitivity in the US increases during divided form of government.

#### **4. Conclusion**

Previous studies have documented that stock prices even have some private information that managers don't have. Chen, Goldstein and Jaing (2007) find evidence that firm managers notice this private information and use stock price to guide their investment decisions. They find a strong positive relationship between a firm's investment expenditures and its market value. Recent studies in political finance find evidence that divided government (gridlock) creates more uncertainty in the stock market relative to the unified government (harmony). Our main goal of this paper is to examine whether firm managers are more likely to use stock prices to guide their investment decision during the divided government compared to the unified government. In other words, we would expect to see a stronger positive relationship between a firm's investment expenditures and its market value during the period of divided government relative to unified government. Using 143,642 firm-year observations from 1952 to 2009 in the United States, we find that investment-to-price sensitivity is two times higher during divided government than during unified government. This finding still holds to our robustness tests. Our findings show that the government's form (divided versus unified) has a significant impact on managers' investment decisions through the information content of stock prices.

**Table 1: Distribution of observation based on year and form of the government**

This table presents the number of firms in the sample by year. It also includes the form of the government in the given year. The sample of firms is from Compustat and CRSP for years from 1952 to 2009. The variable ‘year’ is the regular year in the date, N is the number of firms which are included in the sample in that year and government form is the form of the government in the United States in that year. We obtain the data for the form of the government from various sources. We call the government is *unified* when all three entities :the White house, the House of Representatives and the Senate are under the control of same party and *divided* when at least one of the House or the Senate is not under the control of the party of the president.

Year	N	Government		Year	N	Government	
		Form	Form				
1952	268	U		1981	2,962	D	
1953	272	U		1982	3,009	D	
1954	252	U		1983	3,139	D	
1955	261	D		1984	3,065	D	
1956	266	D		1985	3,229	D	
1957	276	D		1986	3,309	D	
1958	284	D		1987	3,293	D	
1959	305	D		1988	3,495	D	
1960	336	D		1989	3,615	D	
1961	367	U		1990	3,643	D	
1962	439	U		1991	3,602	D	
1963	481	U		1992	3,670	D	
1964	735	U		1993	3,860	U	
1965	806	U		1994	4,059	U	
1966	887	U		1995	4,346	D	
1967	1,038	U		1996	4,472	D	
1968	1,148	U		1997	4,444	D	
1969	1,288	D		1998	4,486	D	
1970	1,467	D		1999	4,319	D	
1971	1,579	D		2000	4,075	D	
1972	1,651	D		2001	4,043	D	
1973	1,829	D		2002	4,038	D	
1974	2,619	D		2003	3,928	U	
1975	2,993	D		2004	3,744	U	
1976	3,217	D		2005	3,575	U	
1977	3,165	U		2006	3,386	U	
1978	3,114	U		2007	3,317	D	
1979	3,045	U		2008	3,285	D	
1980	2,999	U		2009	<u>2,847</u>	U	
					143,642		

**Table 2: Definitions of variables**

Panel A of this table reports the definitions of the variables constructed from Compustat and CRSP from 1952 to 2009. The variables are Investment (I), Firm value (Q), Cash Flow (CF), change in sale ( $\Delta$  sale), reciprocal of total asset (1/A), one year ahead return ( $R_{t+1}$ ), Dummy for the divided government (D), Market Premium (MKT) and inflation (INF). Panel B of the table reports the summary statistics for the above variables. The summary statistics include: Number of observations, the minimum value (MIN), the median value (MEDIAN), the arithmetic mean (MEAN), the standard deviation (SD) and the maximum value (MAX). Investment (I) is expressed as a percentage of the previous year's total asset. All other variables are in decimal and follow the definition from Panel A.

**Panel A: Variable definitions**

<b>Variables</b>	<b>Definitions</b>
Investment (I)	Sum of the capital expenditure and R&D expenses scaled by total assets
Firm value (Q)	Sum of market value of equity and total assets minus book value of equity scaled by total assets
Cash Flow (CF)	Sum of the net income and depreciation and amortization expenses scaled by total assets
Change in sale ( $\Delta$ Sale )	Difference of sale in year t and year t-1 divided by sale in year t-1
One over total Asset (1/A)	One divided by total asset
Return ( $R_{t+1}$ )	One year ahead abnormal stock return calculated relative to CRSP value weighted market index
Divided (D)	A dummy variable taking value 1 if the form of the government is divided and 0 if the government is unified
Market Premium (MKT)	Value weighted stock index minus T-bill
Inflation (INF)	Inflation

## Panel B: Summary Statistics

<b>Variable</b>	<b>N</b>	<b>Min</b>	<b>Median</b>	<b>Mean</b>	<b>Sd</b>	<b>Max</b>
Investment	143,642	0.00	7.92	11.47	12.03	69.98
Firm value	143,642	0.41	1.32	2.04	2.21	15.05
Cash flow	143,642	-0.72	0.09	0.07	0.16	0.44
$\Delta$ Sale	143,642	-0.65	0.10	0.19	0.49	3.35
1/Asset	143,642	0.00	0.00	0.04	0.07	0.44
Return	143,642	-0.92	-0.04	0.05	0.58	2.78
Divided (Dummy)	143,642	0.00	1.00	0.69	0.46	1.00
MKT	143,642	-8.24	1.55	1.07	4.92	12.74
INF	143,642	-0.37	0.39	0.42	0.28	1.40

### Table 3: Summary Statistics based on Divided versus Unified Government

Table 3 exhibits univariate results indicating differences in mean of the key variables during unified and divided governments in the United States. Observation denotes the number of firm year observations and the detailed definitions of other variables are in Table 2. Investment (I) is expressed as a percentage of the previous year's total asset. All other variables are in decimal and follow the definition from Panel A of Table 2. \*\*\* denotes a significant level at 1%.

<b>Variables</b>	<b>Unified</b>	<b>Divided</b>	<b>Diff</b>	<b>P-value</b>
Observation	44,415	99,227		
Investment (I)	11.160	11.612	-0.452	<0.0001***
Firm value (Q)	1.904	2.099	-0.195	<0.0001***
Cash Flow (CF)	0.080	0.064	0.016	<0.0001***
Change in sale ( $\Delta$ Sale)	0.171	0.202	-0.031	<0.0001***
1/Asset	0.031	0.037	-0.006	<0.0001***
Return	0.056	0.044	0.012	<0.0001***
Market Premium (MKT)	0.054	1.529	-1.475	<0.0001***
Inflation (INF)	0.499	0.391	0.108	<0.0001***

**Table 4: Pearson Correlations, Divided v.s. Unified**

This table reports Pearson correlation coefficients for key variables used in the regression. We compute correlations for unified and divided governments separately to see the difference between the relationships among the variables used in the regression. The detailed definitions of the variables are in Panel A of Table 2.

Unified	I	Q	CF	$\Delta$ Sale	1/A	$R_{t+1}$	MKT	INF
Investment (I)	1.00	0.09	0.07	0.01	0.53	-0.01	0.02	0.04
Firm value (Q)	0.09	1.00	0.01	0.01	0.06	-0.02	0.02	0.00
Cash Flow (CF)	0.07	0.01	1.00	0.00	0.17	0.00	0.01	0.00
Change in sale ( $\Delta$ Sale)	0.01	0.01	0.00	1.00	0.00	0.00	0.00	0.01
One over total (1/A)	0.53	0.06	0.17	0.00	1.00	0.04	0.02	0.06
Return ( $R_{t+1}$ )	-0.01	-0.02	0.00	0.00	0.04	1.00	-0.02	-0.01
Market Premium (MKT)	0.02	0.02	0.01	0.01	0.02	-0.02	1.00	0.20
Inflation (INF)	0.04	0.00	0.00	0.01	0.06	-0.01	0.20	1.00

  

Divided	I	Q	CF	$\Delta$ Sale	1/A	$R_{t+1}$	MKT	INF
Investment (I)	1.00	0.16	-0.25	0.01	0.12	-0.01	-0.02	0.01
Firm value (Q)	0.16	1.00	-0.02	0.02	0.06	-0.02	-0.03	0.00
Cash Flow (CF)	-0.25	-0.02	1.00	-0.01	-0.30	-0.01	0.02	0.00
Change in sale ( $\Delta$ Sale)	0.01	0.02	-0.01	1.00	0.01	0.00	0.01	0.00
One over total (1/A)	0.12	0.06	-0.30	0.01	1.00	0.00	0.04	0.03
Return ( $R_{t+1}$ )	-0.01	-0.02	-0.01	0.00	0.00	1.00	-0.06	0.00
Market Premium (MKT)	-0.02	-0.03	0.02	0.01	0.04	-0.06	1.00	-0.21
Inflation (INF)	0.01	0.00	0.00	0.00	0.03	0.00	-0.20	1.00

**Table 5: Multivariate regressions**

This table reports the results of the following panel (firm-year) regressions run on the sample of the US firms from Compustat and CRSP from the years 1952 through 2009.

$$I_{i,t} = \alpha_i + \beta_1 \cdot Divided + \beta_2 \cdot Q_{i,t-1} + \beta_3 \cdot Divided_t * Q_{i,t-1} + \gamma_1 \cdot CF_{i,t-1} + \gamma_2 \cdot Divided * CF_{i,t-1} + \lambda_1 \cdot \Delta S_{i,t-1} + \lambda_2 \cdot Divided_t * \Delta S_{i,t-1} + \varphi_1 \cdot \left(\frac{1}{A_{i,t}}\right) + \varphi_2 \cdot R_{i,t+1} + \varphi_3 \cdot MKT_{t-1} + \varphi_4 \cdot INF_{t-1} + \epsilon_{i,t}$$

Where  $i$  indexes firms,  $t$  years, and  $\alpha_i$  firm fixed effects.  $I$  is firm investment (expressed in percentage),  $Divided$  is dummy variable that takes value of one during the years of divided government and a value of zero otherwise,  $Q$  is firm value,  $Divided * Q$  is the interaction term of divided dummy with firm value,  $CF$  is firm cash flow,  $Divided * CF$  is the interaction of divided dummy variable with firm cash flow,  $\Delta sale$  is growth rate in sale,  $Divided * \Delta sale$  is the interaction of the divided dummy variable with firm growth rate in sales,  $1/A$  is reciprocal of the total assets,  $R$  is future abnormal stock return. Numbers in parentheses are t-values. We drop financial and utility firms. \*, \*\* and \*\*\* denote the significance at 10%, 5% and 1% level respectively.

Variables	Model 1	Model 2	Model 3
Divided	0.32*** (3.40)	3.21*** (4.80)	0.36 (0.76)
Firm value (Q)	1.37*** (17.5)	0.87*** (12.56)	1.37*** (1.96)
<b>Divided * Q</b>	<b>2.90*** (24.41)</b>	<b>0.60*** (5.63)</b>	<b>2.70*** (2.13)</b>
Cash flow (CF)	2.23*** (22.54)	2.835*** (33.69)	2.226 (1.2)
Divided * CF	-7.88*** (-41.51)	-3.97*** (-23.81)	-7.879*** (-3.15)
$\Delta$ sale	0.01 (1.53)	-0.01 (-0.48)	0.01 (0.90)
Divided* $\Delta$ sale	0.01 (0.63)	-0.002 (-0.71)	0.01 (0.35)
1/A	17.61*** (40.79)	31.34*** (55.55)	17.61*** (4.45)
Return (R)	-0.23*** (-4.69)	-0.540*** (-13.17)	-0.234 (-0.88)
Market Premium (MKT)	-0.03** (-2.90)	-0.258* (-2.07)	-0.028 (-0.66)
Inflation (INF)	-1.01*** (-5.98)	-15.48*** (-3.48)	-1.01 (-1.47)
Intercept	10.06 (84.12)		
Firm fixed effects	No	Yes	Yes



Year fixed effects	No	Yes	Yes
Two way clustering	No	No	Yes
N	143,642	143,642	143,642

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