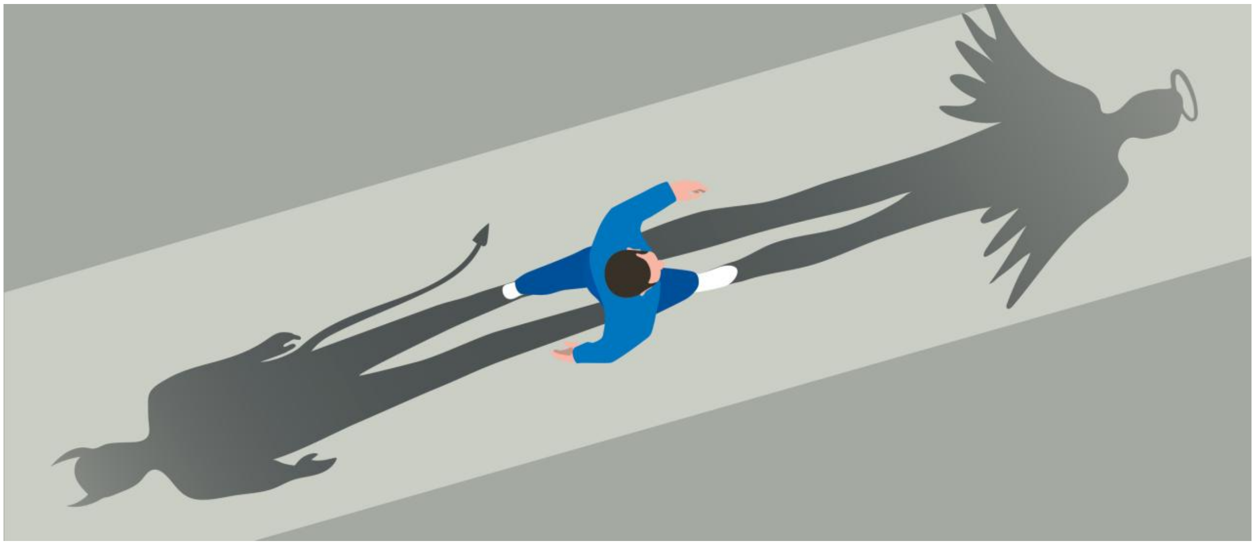
The Problem With Politically Motivated Funding Boycotts



By Theo Vermaelen , INSEAD Professor of Finance

Banks that refuse to back controversial companies create space for less fastidious lenders to step in – and to gain advantage.

United States presidential candidate Elizabeth Warren, like many of her Democratic colleagues, dislikes private prison companies such as CoreCivic. It's a publicly traded real estate investment trust (REIT) and the nation's largest owner of private prisons. On 21 June 2019, **she declared**, "Washington hands billions over to corporations profiting off of inhumane detention and incarceration policies while ignoring the families that are destroyed in the process."

On that news, stock for both CoreCivic and its publicly traded prison competitor GEO Group fell by more than 5 percent. The announcement was especially unfortunate for CoreCivic as the company was preparing to refinance about US$325 million of debt. A few days later on 26 June, the company's long-time lender, Bank of America Corp., announced its intention to stop doing business with the industry.

As the lender explained the motivation behind its decision in a **statement**: "We have decided to exit the relationships we have with companies providing prisoner and immigrant detention services for federal and state governments, as expeditiously as possible… The private sector is attempting to respond to public policy and government needs and demands in the absence of long standing and widely recognised reforms needed in criminal justice and immigration policies. However, lacking further legal and policy clarity, and in recognition of the concerns of our employees and stakeholders in the communities we serve, it is our intention to exit these relationships."

Bank of America followed the example of JPMorgan, which announced in March 2019 it would no longer finance the private prison industry. This move came after activists challenged CEO Jamie Dimon over its financing of prison companies at **the bank's last two annual meetings**.

The Bank of America announcement led to a further decline in **CoreCivic's stock price**. On June 26 CoreCivic **responded**: "Bank of America's decision is about politics, not about the company we are. No other company has led as we have with public commitments to strengthen the re-entry programs in our facilities. No other company has so vocally declared public support for policies at all levels of government to tackle America's recidivism crisis."

Things got still worse for the private prison company when in July 2019 the House Oversight Committee sent letters to CoreCivic and GEO Group seeking information about the facilities they operate under contract from the US government. On 12 October, California announced a ban on for-profit prisons, with the aim of entirely eradicating them from the state by 2028.

Politics and private prisons

CoreCivic and other operators of private prisons always have been in a political hotspot, but more than ever under the Trump administration. The fact that prison management firms' fortunes were heavily influenced by political winds was illustrated in November 2016, when Donald J. Trump won the presidency. The day after the election, stock prices of CoreCivic and GEO Group increased dramatically, making them the biggest winners of the Trump election. This increase largely reversed **the losses since August 2016** when the Obama administration announced that it would begin to phase out private prisons because a study had found that they were largely inferior to public prisons.

Although only 8.2 percent of the U.S. prison population are in private prisons, about two-thirds of US Immigration and Customs Enforcement detainees are held in private centres. Without private prisons it would be difficult for the current administration to implement its immigration policy. Going after private prisons boiled down to going after Trump.

Nomura comes to the rescue

CoreCivic was the target of a two-pronged attack from powerful forces in banking and Beltway politics. But, it didn't take long for **the rescue party to arrive** in the form of Nomura Holdings Inc. The Japanese investment firm was filling the void left by US banks and the private prison company's stock rebounded, although not to pre-June 2019 levels. Risk-averse equity investors may be reluctant to get back into the industry before knowing the outcome of the 2020 election. Moreover, the boycott may have increased the financing costs of the company: its debt was issued at a 4.75 percent yield, 2 percent above bonds with similar credit ratings.

This higher return on debt earned by politically incorrect lenders is similar to the excess returns **investors in sin funds earn** and the discounts accepted by **investors in green bonds**. Investors trade-off **"alpha in heaven"** against alpha on earth.

The basic conclusion is that simply boycotting financing of politically incorrect businesses creates opportunities for others who are less concerned with political correctness. Although CoreCivic's cost of capital may increase as a result of these boycotts, that only redounds to the benefit of the new politically incorrect investors, which will earn above normal returns.

Abandoning the purist stance

The fact that CoreCivic, slapped down by activist pressure, nonetheless bounced back illustrates that the buoyancy of the free market can defy the weightiest good intentions. This leaves change agents with few promising avenues for controlling corporate behaviour – unless they are willing to abandon a purist stance.

In 2016, I set forth in these pages a **modest proposal** for combining "sin investing" with doing good. In a nutshell, portfolio managers buy whatever stocks they choose, including those of companies whose products are disfavoured by elites e.g. tobacco and handguns (which tend to beat the market). Each quarter, the fund would report profits derived from disreputable stocks so that investors could donate that amount to their favourite charity, thereby balancing the moral scales.

Perverse though it may sound, some kind of Jekyll & Hyde-style solution like sin investing combined with charitable donations would be change advocates' best bet for making a real impact. Otherwise, political activism pursued through the market will most likely produce a deeply undesirable ratio of moral grandstanding to actual results.

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