INVESTOR VALUTION:
LGBTQ INCLUSION AND THE EFFECT ON A FIRM'S FINANCIALS

By

GARRETT DANIEL VOGE

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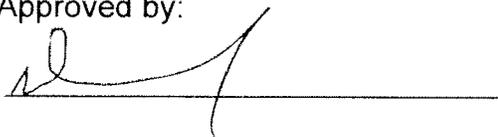A Thesis Submitted to The Honors College

In Partial Fulfillment of the Bachelors degree
With Honors in

Accounting

THE UNIVERSITY OF ARIZONA

MAY 2013

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Degree title (eg BA, BS, BSE, BSB, BFA):

BS

Honors area (eg Molecular and Cellular Biology, English, Studio Art):

Accounting

Date thesis submitted to Honors College:

5/1/13

Title of Honors thesis:

Investor Valuation: LGBTQ Inclusion and the Effect on A Firm's Financials

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Abstract:

This study examines whether institutional investors value LGBTQ workplace initiatives differently than common investors. To investigate this issue, I analyze the stock market reaction to the release of the 2012 Corporate Equality Index (CEI) scores from the Human Rights Campaign to identify the difference for firms depending on the level of institutional ownership. My findings suggest that firms with a higher ownership percentage of institutional investors have a significantly positive increase in stock prices when they release high CEI scores. This suggests that institutional investors see value in corporate LGBTQ policies.

Introduction:

In recent years, companies have realized the growing need to cater to unique lifestyles and have implemented different policies (flexibility, work from home, time off for adoptions, same-sex domestic partnership benefits, etc.). Some studies show that these "tailored" policies enhance team cohesion, creativity, morale, retention and thereby increase overall firm value (Henneman, 2004; Stocum, 2006; Tejeda, 2006; Turner, 2004). However, other studies reveal that human resource decisions provide no relevant information to the stock market, thus creating additional costs to a firm with no substantial benefit (Hannon, 1996). Given the growing Lesbian, Gay, Bisexual, Transsexual and Queer (LGBTQ) population, U.S. companies are increasingly implementing or considering implementing LGBTQ-inclusive policies and business strategies. Thus, it is important to focus on LGBTQ corporate policies as one specific human resource decision and examine whether such policies provide value to firms.

Prior literature has reached conflicting results when examining the effects of LGBTQ policies on firm value (Johnston & Malina, 2008; Wang and Schwarz, 2010). Some studies have argued that these policies increase firm value since stock prices are positively affected when they are implemented (Wang and Schwarz, 2010). However, other studies provide evidence that the effects of these policies fluctuate and draw no conclusions about firm value (Johnston and Malina, 2008). There has been no study to date that has recognized the varying levels of investor sophistication when compared to the implementation of LGBTQ-friendly workplace initiatives. Given prior studies that document institutional investors as more able to distinguish the cash flow implications and value of a firm, this study examines whether institutional investors and common investors value LGBTQ–friendly workplace policies differently.

The inconsistent results in prior literature regarding the value of LGBTQ policies might be due to the inherent differences between institutional investors and common investors. Institutional investors, such as banks, hedge funds and insurance companies, have significantly more resources than common investors to value a firm. Consequently, prior literature identifies institutional investors as better able to predict future cash flows from company financials and policies. LGBTQ policies, like other human resource policies, are human resource decisions that are difficult to value. Thus, I am motivated to

use the sophistication of institutional investors to examine whether LGBTQ policies increase firm value.

This paper contributes to two streams of literature. First, my study contributes to the debate within literature about the value of human resource decisions. Using the more sophisticated ability of institutional investors to predict future cash flows, I provide evidence that LGBTQ corporate policies are value increasing. Second, this paper contributes to the stream of literature examining differences between institutional investors and common investors. Through examining a human resource policy that is more ambiguous in value, I provide evidence that institutional investors react differently than common investors. This finding suggests that institutional investors do in fact estimate different future cash flow implications of company policies.

Background:

Managers must consider many different pressures in their decision-making processes. Different stakeholder's reactions to these decisions are vital to a company's success in the marketplace. Freeman (1984) defined the stakeholders as "any group or individual who can affect or is affected by the achievement of the organization's objectives". Currently, a significant and expanding stakeholder group for large companies is the LGBTQ community. Many of the rights of these stakeholders differ depending on the state, industry and company that they work for since there are few federal mandates about LGBTQ rights. However, there are external entities, such as the Human Rights Campaign, that rank different companies with regards to their LGBTQ-friendly policies with a Corporate Equality Index (CEI) score. This ranking is a culmination of data from self-reported surveys, press releases, employee resource groups and their advocacy groups that measures how extensively a company manages sexual orientation diversity issues (Johnston and Malina, 2008).

Recent studies have estimated that LGBTQ employees represent 2.5% of the population, amounting to over 5 million employees nationwide (Johnston & Malina, 2008). The LGBTQ community represents 21 million people in the consumer marketplace who spend about $641 billion on goods and services (Witeck & Combs, 2006). Due to fear of backlash, industry acceptance and personal privacy, these estimates are thought to be low because of the difficulty in assessing the basic demographic of LGBTQ populations. Firms have taken note of these statistics. Managers realize that a growing number of consumers, employees and other stakeholders are associated with the LGBTQ community. Thus, firms are increasingly revamping corporate diversity policies to include LGBTQ needs.

Corporate Diversity:

Managers pay close attention to human resource (HR) policies since HR problems are among the most common reasons that small firms fail (Lussier and Pfeifer, 2001). Since the most frequently asked question by executives regarding corporate policies and workforce diversity is how it affects organizational performance, it is important to understand the motives behind implementing specific policies (Cox, 1994).

There are specific studies that provide evidence of a positive relation between a firm's total percentage of women managers and the firm's performance (Shrader, Blackburn, & Iles, 1997). Other studies depict the positive effects on financial performance of having racial diversity among employees (Richard, McMillan, Chadwick & Dwyer, 2003). These studies, in sum, show that the employee composition of a firm directly affects the firm's value.

In turn, reference to diversity management refers to a company's policies rather than the composition of its employees and related studies overall find positive effects of more diverse company policies. Blau (1964) argues that nondiscrimination programs result in positive stakeholder responses since, "people should help those who have helped them." Also, it has been argued that intangible assets such as corporate image and reputation are greatly benefitted when progressive and accepting policies are implemented or announced. Flamholtz (1985), Cascio (1991) and Huselid (1995) concluded that progressive human resource management practices generally yield positive financial returns. For example, being named as a best company for working mothers is associated with positive market returns around the announcement date (Hannon and Milkovich, 1996). Also, affirmative action programs result in positive performance impacts (Corns & Schotter, 1999; Wright, Ferris, Hiller, & Kroll, 1995).

LGBTQ Initiatives:

Given the increase in the LGBTQ population, LGBTQ-friendly workplace policies have been at the forefront of managers' minds when it comes to diversity management. Critics of these LGBTQ policies argue that the risks of backlash and the inappropriate use of funds for social issues ultimately hurt a firm. Since 48% of people view the LGBTQ community as "morally wrong," disputes and boycotts are inevitable (Gallup Inc., 2008). Some companies that have key demographics or employees in very religious areas of the country might suffer if liberal, LGBTQ policies were implemented. Arguments about how investments in LGBTQ practices overstep management's responsibility to shareholders suggest that increases in unnecessary costs and consumption of company resources will decrease firm value as a whole.

However, there are many studies that present counter-arguments as well. For example, the 2005 Gallup poll stated that workers with a higher commitment to diversity were more likely to stay longer and recommend their company to others. Firms that are trying to show the value of diversity have implemented same-sex domestic partnership benefits, diversity training and other nondiscrimination policies (Button, 2001; Hoye and Lievens, 2003; Johnston and Malina, 2008). Overall, there is much debate over what policies should be implemented and how these will affect firm value.

Academic research has also led to conflicting conclusions recently related to the value of LGBTQ corporate policies. In sum, empirical studies have found that these new LGBTQ-friendly policies either: (a) hurt or do nothing for firm value, or (b) increase firm value (Johnston & Malina, 2008; Wang and Schwarz, 2010). Specifically, Wang and Schwarz (2010) find that "more progressive GLBT nondiscrimination practices and policies relative to competing firms in the same industry contribute to sustaining a competitive advantage in the marketplace, as shown by positive stock price reaction in the following years." However, other studies conclude that there isn't a significant

reaction to such progressive practices. "Stockholders do not react unfavorably to resource allocations for social purposes, specifically those attributable to sexual orientation workplace policies," (Johnston & Malina, 2008). In sum, it is apparent that the value of LGBTQ policies is uncertain but important to ascertain given the increasing LGBTQ population as employees and consumers.

Investors:

Investors analyze many different aspects when assessing the value of a company and the potential benefits of investing in a firm. Prior studies have concluded that there are different types of investors but that generally, investors have varying degrees of sophistication when it comes to valuing firms.

Lang (1997) describes two types of investors when he states, "institutional trading behavior differs from that of other investors." Since institutional investors as a group own more than half of the US publicly traded equities and make up more than 50% of all trades in the US stock market, these investors are becoming more influential (Cai et al., 2002). Institutional investors are thought to be more sophisticated with regards to the information that they use to make decisions about trading stocks (Ke, 2004). These better informed investors arguably can better estimate how current firm financials and policies predict future returns (i.e. firm value). Because these investors pay closer attention to new policies and the practices of companies, I expect their reactions to companies implementing LGBTQ- friendly workplace policies to be different than the reactions of common investors.

Hypothesis Development:

Given institutional investors' incremental interest and sophistication in determining a firm's future cash flows based on current financials and firm policies, I expect these investors – more so than traditional investors, to notice and react to a firm's use of value-relevant policies. More specifically, information about a company's human resource policies often is transmitted via interest group studies and news articles. I expect institutional investors to more likely identify such information, estimate the related future cash flow implications, and react accordingly to the news. If institutional investors and common investors similarly identify news related to a firm's human resource policies and estimate similar future cash flow implications, I expect market reactions to news about such policies to be the same regardless of the level of institutional ownership in a firm. However, if institutional investors and common investors differ in either their awareness of new information or their estimates of future cash flows, there will be a difference in the stock market reaction to value-relevant news.

To study institutional investors' valuation of LGBTQ corporate policies, I use an annual report published by the Human Rights Campaign (HRC). This report ranks companies from the *Fortune* 500, *Forbes* Private 500, and other companies with at least 500 employees on how they manage sexual orientation diversity issues. The CEI measures factors such as nondiscrimination policies covering sexual orientation and

diversity training that includes sexual orientation and/ or gender expression in the workplace (Johnston & Malina, 2008). With conflicting opinions on whether the level diversity management a firm has (CEI score as the proxy), I incorporate a new variable, the institutional investors variable to see if this accounts for the ambiguity of past studies. I test the following hypothesis:

Hypothesis 1: The stock market reaction to a firm's CEI score will vary with the firm's percentage of institutional investor ownership.

Data:

This study consisted of multiple steps and will closely follow the Johnston and Malina (2008) research paper for the empirical model and the data. First, I identified the date that the stock market received the CEI scores, which was December 8th, 2011 at noon. This information was released in a news conference and reported on by the Associated Press and other news sources shortly after(sources such as the Associated Press gave links to the full HRC listings if investors wanted to retrieve this information). Thus, at noon on December 8th, 2011, easy access to the list of CEI scores was available to the stock market. We define this date as Day 0 in the study and mark it as the event date.

Next, I calculate the abnormal stock market reaction related to the release of a firm's CEI score. In order to calculate a firm's abnormal return for a particular day, one must use a firm's actual return and subtract an expected return given the history of that stock and the market. I used the historical period from December 1, 2010 to December 1, 2011 to calculate a firm's alpha and beta. By pushing it to December 1st rather than the event date of December 8th, leaked information will be minimized. Using each firm's daily stock returns for this period, the needed beta and alpha were obtained using the following empirical model:

(1) Historical Return $_{day\ i}$ = α + β (Historical Market Return $_{day\ i}$) + ϵ

The historical return is the actual stock return and was computed for each firm and each date (the 247 trading days). Historical market returns are the daily returns on the Center for Research in Security Prices value-weighted index. The above model produced an estimated alpha and beta for each firm, which were used in the next model to calculate the expected return for the event date.

(2) Expected Return $_{day\ i}$ = α + β (Market Return $_{day\ i}$)

Finally, the following empirical model depicts the calculation of each firm's abnormal return obtained by using the calculated expected return and actual return on December 8th, 2011:

(3) Abnormal Return $_{day\ i}$ = Actual Return $_{day\ i}$ – (Expected Return $_{day\ i}$))

To empirically test my hypothesis, I examine whether the abnormal stock market return on the event date is different based on a firm's level of institutional ownership. I interact the CEI Score dependent variable with a variable measuring the level of institutional ownership in a firm. The following is the empirical model used:

(4) Abnormal Return $_{day\ i}$ = α + β_1CEI + β_2 IO + β_3 CEI*IO + β_4 Firm Size + β_5 Industry Controls + ϵ

I control for firm size and a firm's industry as prior suggests that these firm characteristics explain variations in firm valuation (Frink et a., 2003 and Johnston and Malina, 2008). I control for firm size by including the natural log of total assets from the end of the most recent fiscal year in equation 4 (Richard, 2000). The industry control is a dichotomous variable that equals one if the firm operates in a 2-digit Standard Industrial Classification Code (). β_2 is the coefficient for the institutional ownership variable, which is the number of outstanding shares owned by institutional investors divided by the total outstanding shares of the firm. β_3 is my main variable of interest, which identifies whether the percentage of institutional investors explain the variation in abnormal returns on the event date. My hypothesis is null and thus I expect abnormal returns to be no different when the CEI and institutional investor variables are introduced. If institutional investors value a higher CEI score and react to such information, then the abnormal market reaction would be more positive and β_3 would be positive and significant.

Sample:

My sample is composed of the 869 firms that the HRC rated in 2012. These firms are drawn from the 2011 Fortune 1000, 2011 AM Law 200 and any private-sector, for-profit employer with over 500 full-time U.S. employees that requests to do so. Firms that could not be found in our database system COMPUSTAT, which amounted to 353 firms, reduced the sample size. Seventy additional firms without the needed financial information for my tests were subsequently subtracted from the sample. Thus, my final sample size is 446 firms. This process is outlined in Table 1 below.

Table 1
Sample Selection Process

Firms with 2012 CEI scores	869
Less privately held firms and/or firms unable to match to Compustat	(353)
Subtotal	516
Less firms with missing return and/or financial data	(70)
Final sample size	446

Note: CEI= Corporate Equality Index.

Descriptive Statistics:

Table 2 describes the frequency distribution of the 446 firms by industry membership. Utility companies are the largest of all the different industries represented. However, the sample is not heavily concentrated because not one industry has more than 10% of the total sample.

Table 2
Frequency Distribution of Observations (by 2-Digit SIC Codes)

SIC Code and Industry	Number of Observations	Percentage of Observations in Sample
2000: Food and kindred products	17	4%
2800: Chemicals	29	7%
3500: Industrial machinery	19	4%
3600: Electrical equipment	18	4%
3700: Transportation equipment	22	5%
4800: Communications	19	4%
4900: Utilities	42	9%
6000: Depository institutions	19	4%
6300: Insurance carriers	18	4%
7300: Business services	29	7%
48 other 2-digit SIC codes	214	48%
Totals	446	100%

Note: SIC= Standard Industrial Classification.

Table 3 describes the frequency distribution of CEI scores for 2012. As you can see, the median CEI score is 60, while the mean CEI score is 56. Thus, during the 2012 year, it seems that most firms ranked have at least some LGBTQ-friendly workplace policies in place.

Table 3
Frequency Distribution of CEI Scores Across Sample Firms

CEI Score	Frequency	Percent
-25	1	0%
0	38	9%
10	2	0%
15	84	19%
20	4	1%
25	4	1%
30	30	7%
35	8	2%
40	7	2%
45	11	2%
50	12	3%
55	2	0%
60	22	5%
65	10	2%
70	15	3%
75	19	4%
80	10	2%
85	25	6%
90	51	11%
95	3	1%
100	88	20%
Total	446	100%

Mean CEI Score	56
Median CEI Score	60

Table 4 describes four different ranges of time around the event date. Each is unique and important to analyze since released data disperses into the market at different rates. CAR3 depicts the abnormal return while looking at days -1, 0 and 1. CAR2 shows the abnormal returns for days -1 to 0. CAR2_2 is used for days 0 to 1. Lastly, CAR1 is simply the abnormal returns on day 0.

Table 4
Descriptive Statistics

Variable	N	Minimum	1st Pctl	10th Pctl	Median	Mean	90th Pctl	99th Pctl	Maximum	Std Dev
CAR3	446	-5.90	-5.90	-2.51	-0.07	-0.14	2.09	5.22	5.22	1.99
CAR2	446	-4.17	-4.17	-2.20	-0.16	-0.14	1.76	4.74	4.74	1.63
CAR2_2	446	-5.59	-5.59	-2.00	0.00	-0.12	1.80	3.54	3.54	1.59
CAR1	446	-3.22	-3.22	-1.64	-0.07	-0.13	1.22	3.09	3.09	1.11
pctIO	446	0.00	0.00	0.49	0.81	0.75	0.96	1.00	1.00	0.22
firmsize	446	6.77	6.77	7.88	9.48	9.63	11.57	14.16	14.16	1.43
Alpha	446	-0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Beta	446	0.33	0.39	0.58	1.11	1.12	1.64	2.13	2.31	0.40

Table 5 below shows the mean abnormal returns and univariate statistics. Panel A allows us to see if the abnormal returns are equal to zero. As one can see, the abnormal returns are slightly negative, suggesting that if anything, there is a negative correlation between CEI Score and the abnormal market reaction. Panel B reveals that there is a significantly negative relationship between CEI Score and the abnormal market reactions for CAR1 and CAR2. When looking specifically at the abnormal returns for sample firms below and above the median institutional ownership, nothing significant resulted. There appears to be a negative correlation between CEI score regardless of a firm's institutional ownership.

Table 5
Mean Abnormal Returns and Univariate Statistics

Panel A: Mean abnormal returns

Day -1	Day 0	Day +1	Days -1, 0, 1
-0.025	-0.127	0.006	-0.141

Panel B: Abnormal returns for all sample firms

	Obs.	Mean	P-Value
CAR3 (-1,0,1)	446	-0.1414	0.1333
CAR2 (-1,0)	446	-0.1437	0.0641***
CAR2_2 (0,1)	446	-0.1223	0.1046
CAR1 (0)	446	-0.1274	0.0156**

Panel C: Abnormal returns for sample firms below and above the median
institutional ownership percentage

	Below Median	Above Median
Obs.	223	223
Mean	-0.134	-0.121

***, **, * denote significance at the .10, .05, .01 level

Table 6 depicts no significance with regards to abnormal returns when looking at the span of time from day -1 to 0 (CAR2) and day -1 to 1 (CAR3). Similarly, the coefficient that we are looking at that incorporates CEI and institutional ownership is not significant in the span from day 0 to 1 (CAR2_2). However, in CAR1 (day 0) the coefficient for the correlation between CEI score and institutional ownership is significant and positive. This finding is consistent with Hypothesis 1 and suggests that firms with higher CEI scores experience positive abnormal returns as their level of institutional ownership increases. Johnston and Malina (2008) revealed similar results and only had significance on day 0 as well. This could be due to the fact that investors react very fast to new information in the market.

Table 6
Regression of Abnormal Return on CEI Score and Insitutional Ownership

| | CAR1 (0) Day 0 | | CAR2_2 (0,1) Day 0, 1 | | CAR2 (-1,0) Day -1, 0 | | CAR3 (-1,0,1) Day -1, 0, 1 | |
| | Coefficient | | Coefficient | | Coefficient | | Coefficient | |
	T-Statistic	P-Value	T-Statistic	P-Value	T-Statistic	P-Value	T-Statistic	P-V:
CEI Score	-0.014		-0.004		-0.007		0.003	
	-2.580	0.0100**	-0.600	0.551	-0.710	0.480	0.270	0.:
Firm Size	-0.029		-0.201		0.121		-0.057	
	-0.530	0.594	-2.580	0.0102**	1.550	0.121	-0.610	0.:
Institutional Ownership	-1.129		-1.243		-0.592		-0.728	
	-2.780	0.0056*	-2.010	0.045**	-0.710	0.480	-0.770	0.:
CEI Score*Institutional Ownership	0.020		0.009		0.014		0.001	
	2.900	0.004*	0.930	0.353	1.120	0.265	0.100	0.:
Adjusted R^2	0.274		0.282		0.265		0.287	
N	446.000		446.000		446.000		446.000	

***, **, * denote significance at the .10, .05, .01 level

Conclusion:

Although some firms are actively moving towards policies that are progressive with regards to LGBTQ equality, others are not. Currently, academic research documents inconsistent results as to the value of LGBTQ corporate policies. This event study looked at the institutional ownership of a firm to see if common investors and institutional investors value LGBTQ progressive policies differently. My findings suggest differences in investors' valuations of LGBTQ corporate policies might explain the contradictory results of prior literature.

Using CEI scores, as published on December 8th, 2011 by the Human Rights Council, I examine abnormal market returns for firms. When looking specifically at the event day (day 0), I found a positive relation between sexual orientation diversity management (proxy being the CEI score) and abnormal returns when the institutional investor ownership increased. In other words, institutional investors appear to respond more positively to higher CEI scores than do common investors. Firms with a higher institutional ownership experience positive and significant market reactions to higher CEO scores.

Although there are still many issues in the workplace for the LGBTQ community, this study helps to continue the conversation of the positive benefits of these policies. Since institutional investors know more about the stock market and are often more educated in the realm of finance, one might deduce that these progressive policies likely increase a firm's value in the future.

However, my study is limited in its contribution as there are many problems that should be addressed. CEI scores do not measure any level of implementation and thus cannot shed light on the idea of intentions rather than outcomes of LGBTQ diversity management. This study also assumes that all investors have access to the HRC CEI reports for the year and that the market is efficient. This study does not look into multiple years and see the effect, if anything, of changes in the HRC scores over time. I leave a study examining reactions to changes in HRC scores to future research. It will be

interesting to see if companies continue to support LGBTQ workplace initiatives in the future and the affects that these current policies will have on future policies on employees, customers and overall firm health.

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