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Senators Beat the Market with Insider Information

By Max Holland

The United States Senate is often called "the most exclusive club in Washington," or exalted by its members as the "world's greatest deliberative body." But a new appellation may be in order: the world's best investment club.

According to a study conducted by four business professors, in any given year between 1993 and 1998, roughly 1/3 of all senators played the stock market, and those who did enjoyed an "abnormal" rate of return, meaning they out-performed the market. Senators consistently anticipated movements in stock prices: they often purchased stocks just before prices took off like a rocket, and revealed an uncanny ability to sell just when a stock was about to flatten out.

For some perspective, the authors of the study (university professors Alan Ziobrowski from Georgia State; Ping Cheng from Florida Atlantic; James Boyd from Kent State; and Brigitte Ziobrowski from Augusta State) compared the senators' performance with that of two groups. The first is the investing public: 66,465 randomly selected households in the United States that were studied in 2000. This group underperformed the market by approximately 1.4 percent annually from 1991 to 1996. The authors also compared the senators' performance with a 2001 study of corporate insiders during the period 1975 to 1996. This group beat the market by about 6 percent annually—lending credence to the old Wall Street adage that you rarely go wrong if you buy and sell when the insiders do.

Yet being a corporate insider, and presumably trading on the basis of privileged information, apparently pales next to being a senator. The Ziobrowski et al. study found that senators (including their spouses and dependents) outperformed the market by around 10 percent annually. "Nobody gets results like this in the financial world consistently and over the long term," notes Professor Tom Ferguson, who studies money in politics at the University of Massachusetts-Boston. Any manager of a mutual fund, in fact, who regularly beats the market by as little as two percent annually is considered an investment genius.

Since it cannot be a statistical fluke, the most plausible explanation for this achievement is that senators, by virtue of their powerful office, are made privy to such privileged information, and that some choose to capitalize on it. It's unlikely that stock tips are being exchanged during whispered conversations in Capitol Hill cloakrooms, or that senators are the first to realize the economic repercussions of complicated legislation. Rather, senators' acumen comes from being "embedded in social networks that provide them with access to valuable information," as the professors put it. Think of it as the Martha Stewart scenario writ large.

The study found no statistically significant difference between the abnormal returns earned by Democrats versus Republicans over the six-year period. Seniority, however, appeared to be a significant factor. Surprisingly, those with the least seniority (e.g., in their first six-year term) achieved higher abnormal returns than senators who had served at least two terms. This suggests that lucrative investments of other kinds may flow more easily to established senators who wield more power, say, committee chairmen.

Mark Twain's observation, first offered more than 100 years ago, seems pertinent. If your congressman comes back to your state to run for re-election and is not coming home a millionaire, noted Twain, "he is a fool and should be turned out of office."

To be sure, senators who trade are not doing anything illegal, or even unethical, according to the Senate's internal standards. Stock trading on the basis of privileged information is not even addressed in the Senate's Ethics Manual. Senators are prohibited from directly "cashing in" on legislation they work on; yet overall the rules governing their financial conduct are quite liberal. Senators are not required to "strip themselves of worldly goods" upon taking office, nor are they disqualified from voting on issues that generally affect their personal fortunes.

Interpreting the ethics code is largely up to the members. At one end of the spectrum lies Richard Lugar (R-Indiana), a senator for 28 years, who decided when he entered politics in 1967 that holding individual stocks was incompatible with public service. Lugar invests only in diversified mutual funds, and each year releases a balance sheet of his assets and liabilities that goes well beyond what is legally required. At the other end is Ted Stevens, the senior Republican in the Senate who is also known as Alaska's "senator for life," having represented that state since 1969. Stevens invests in dozens of individual stocks, including telecommunications and technology companies that fall directly under the jurisdiction of the Commerce Committee, which he chairs.

Because of the wide latitude allowed, sunlight is deemed the best disinfectant. Since 1978, senators have been required to disclose all their personal financial holdings (and those of their spouses and dependents) in an annual Financial Disclosure Report (FDR). This yearly exercise is considered the most effective mechanism for deterring gross conflicts of interest or egregious self-enrichment.

The supposed transparency of the FDRs, however, is not all that it is cracked up to be. And this is the other troubling aspect exposed by the new study. The trading data available in the FDRs presented a host of problems. While some senators simply attached the monthly financial statements from their brokerage firms to the FDR, others provided only handwritten notations or abbreviations that the professors found impossible to decipher.

More significantly, senators are only required to report their gains within eleven broad bands ($1,001 to $15,000, $15,001 to $50,000, and so forth), and so the exact amount of their profits cannot be measured. In order to perform their analysis, Ziobrowski and his fellow professors had to create imaginary portfolios that mimicked the buy-and-sell transactions the senators engaged in. While this methodology in no way invalidates the study's key finding, it dulls the political point with respect to specific senators when a dollar amount cannot be attached.

Indeed, the "banding problem," as it's known to money-in-politics cognoscenti, is a serious defect in the FDRs because it obscures almost as much as it reveals. One member of Congress, for instance, listed assets, in bands, that totaled somewhere between $813,000 and $1.7 million in 1996. This same member, nine years later, listed assets totaling somewhere between $2.4 million and $8.1 million. The gap between those numbers suggests two very different portraits: a member who is either simply a prudent investor, or someone who rivals Warren Buffett, albeit by exploiting, in all likelihood, the boundless perks available to elective officeholders. These opportunities encompass everything from getting in on the ground floor of initial public offerings of stock, to sweetheart real-estate deals. Ted Stevens once turned a $50,000 investment with an Anchorage real-estate developer into $1.03 million in seven years.

Senators' ability to time the stock market is one reason why at least 60 senators are worth at least $1 million now. As recently as 1994, only 28 senators had a net worth of that amount or more, and their salaries (currently $162,100) have not gone up fast enough in that 11-year period ($28,500) to account for this increased wealth.

The Senate, of course, has always had its share of members unable to distinguish between their own personal fortunes and the nation's. The late Robert Kerr (D-Oklahoma), the "uncrowned king of the Senate" in the 1950s, comes to mind. Born in a log cabin, but the wealthiest man in the Senate by far during his years of service, Kerr was infamous for privileging oil and gas interests, including his own company (Kerr-McGee), from his perch on the Finance Committee. Kerr believed doing business in the Senate was no different than doing business on the outside: Everything was predicated on a quid pro quo basis.

Besides venal members, the Senate has always had its fair share of "empty suits," senators whose main qualification is that they look or sound like Central Casting's idea of a senator, as well as more than its share of ambitious politicians who regard the upper house primarily as a steppingstone. But what seems different now, and what makes these charming peccadilloes and real shortcomings harder to swallow, is that so few senators seem capable of, or committed to, fulfilling their responsibilities as public servants. Seldom in its history has the Senate seemed so removed from what the Founding Fathers envisioned: the place where the power of the executive branch and House could be checked, and the forum for "express[ing] sober second thought on national priorities," as Lewis Gould put it in his recent history of the Senate, *The Most Exclusive Club*.

The restraint of executive power has seldom been weaker. During the last decade, under Presidents Clinton and Bush, and without a declaration of war, the U.S. has bombed Serbia's Slobodan Milosevic into submission; toppled the Taliban in Afghanistan; and instigated a war of choice to overthrow Iraq's Saddam Hussein.

Towards the end of the Vietnam War, the 1973 War Powers Act was put in place to check the commander-in-chief's ability to commit American lives and treasure; the Senate spearheaded passage of the act. Although largely symbolic, it at least held out the promise of forcing meaningful debate over the issue of war. But nowadays the Senate is likely to give a transportation bill more thoughtful deliberation than a decision to commit American soldiers, as Leslie Gelb and Anne-Marie Slaughter noted in a November article in *The Atlantic*. Reportedly, only six senators read the classified intelligence estimate on Iraq before voting to authorize the use of force there.

The weakness of the contemporary Senate is not only reflected in the absence of stirring debate on pivotal issues. It's evident nearly every working day. It's the rare senator who can ask extemporaneous questions of a witness before a committee. The impulse for serious investigating, which is time-consuming, hard work, is also all but dormant. Despite the stunning intelligence failure that preceded the war in Iraq, the Intelligence Committee has yet to explore the Bush administration's misuse of the flawed estimates produced by the intelligence community. More recently, the Senate roused itself, at least temporarily, and blocked renewal of the Patriot Act. But that only occurred because, on the day of the vote, many senators apparently learned from reading *The New York Times* that President Bush had signed a secret and unprecedented order in 2002 authorizing the National Security Agency (NSA) to conduct warrant less intercepts and wiretaps domestically. Traditionally, the NSA has been highly restricted in its operations inside the United States.

One has to go back to the Gilded Age to find a time when the Senate seemed of equal inconsequence. At that time, senators were widely criticized for being captive to moneyed interests and bent on self-enrichment. It was thought that these twin evils stemmed from the fact that senators were elected by state legislatures rather than by popular vote.

Apparently not.

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