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If All Politics Is Local, So Is Much Investing

By MARK HULBERT

FAMILIARITY may breed contempt elsewhere in life - but not, apparently, in the financial markets. On the contrary, investors tend to buy more of a company's stock when the business is close to home.

According to a recent academic study, this tendency has profound implications for the stock market.

The study, "[Does Corporate Headquarters Location Matter for Stock Returns?](#)" is forthcoming in The Journal of Finance. Its authors are Christo A. Pirinsky, an assistant professor of finance at Texas A&M, who is also a visiting professor this year at Rutgers, and Qinghai Wang, an assistant professor of finance at the University of Wisconsin at Milwaukee.

The researchers found that the stocks of companies whose headquarters are in the same geographical area tend to rise and fall together. That means that the stocks of two companies based in Boston, for example, are more likely to move in tandem than those of two companies based thousands of miles apart.

The professors could not find any rational explanation for this pattern. They found that it could not be attributed, for example, to the tendency of companies in the same industry to be based in the same region - the way the high-tech industry, for example, is centered in Silicon Valley. When measuring the correlation of a given region's stocks, the professors controlled for the tendency of stocks in the same industry to move up and down together. The phenomenon they discovered exists above and beyond this industry effect.

One of the more telling findings involved companies that moved their headquarters from one part of the country to another. Before such moves, their stocks were relatively highly correlated with those of companies near their old bases - and showed very little correlation with those in the areas where they would relocate.

After the moves, however, the pattern reversed. The stocks lost most of their correlation with those of their old regions and became highly correlated with those in their new regions.

A good illustration, according to the professors, is [Nextel Communications](#), which moved its headquarters in 1996 to McLean, Va., near Washington, from the New York suburb of Rutherford, N.J. After the move, its stock became less correlated with those of New York-area companies and more so with those in and around Washington. (Nextel was recently acquired by Sprint.)

To the professors, the probable explanation is that many investors are more inclined to buy the stocks of companies in their regions. After all, these are the companies with which they are most familiar - the ones most likely, for example, to pop up in conversations with other local investors.

When investors in a region become more bullish, they tend to distribute their purchases across all companies based there - a rising tide that raises all boats. But this can also lead a region's stocks to decline more or less together - when a region's investors decide to reduce their equity exposure, for example. Because they tend to be disproportionately invested in the region's stocks, their selling will necessarily be concentrated in those issues.

That behavior seems irrational, because it involves buying and selling stocks with little regard for earnings, book value or other measures of fundamental value. Yet the professors found further evidence of the pattern when they focused on various measures of investor sophistication. They found, for example, that the pattern is strongest among stocks held primarily by individual investors. The likely explanation, according to the professors, is that irrational factors like headquarters geography are more likely to influence individual investors than institutions like pension funds and endowments.

The findings have important investment implications. One is that the definition of diversification should be expanded. Until now, a portfolio was considered adequately diversified if it had enough stocks in enough different industries. The professors argue that a diversified portfolio should also include companies whose headquarters are dispersed across many regions.

The study also points to a new way to search for undervalued and overvalued stocks: First, consider the stocks of companies from a region whose stocks have been in favor. Because investors in that region may bid up all such companies' stocks without much regard for their underlying value, there may be some whose prices are unjustifiably high.

The opposite is likely to be the case in a region whose stocks have performed particularly poorly. Because investors in that region may have indiscriminately sold the stocks of all local companies, there may be some whose prices are undeservedly low.

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