

Political Risk and Shareholder Wealth – The Case of US Firms with Cuban Exposure

Jeffery A. Born

Abstract

In an informationally efficient market, the value of a firm's common stock should move inversely to changes in political risk. We examine the changes in the value of 50 firms that ultimately filed claims for expropriation losses, to events in Cuba that culminated in the Batista government abdicating, Castro taking power, and ending with the failed Bay of Pigs 'invasion'. In the aggregate, the market responded negatively to rebel gains, and losses increased as Castro adopted confiscatory policies. We split the sample into three groups; those firms with (very) large exposures suffered the most severe losses. Firms with trivial or small exposure were typically unaffected by changes in political risk and ultimately by expropriation. We interpret the later finding as consistent with the hypothesis that the 'losses' were an acceptable cost of doing business in economies with elevated political risk (relative to the US).

Keywords: CAPM, political risk,

1. Introduction

Political risk can be defined as non-zero probability that an individual's or organization's wealth will be altered by a government decision(s) or by political instability. Rarely are such government decisions completely unexpected. Likewise, incidents of political instability don't usually arise out of the ethos. In an efficient market, asset prices would be expected to reflect the consensus of investor views on the impact of political risk. When the political risk event is sudden and unexpected, the reaction of asset prices should be swift and complete, if risk ebbs and flows, we expect asset prices to do the same.

During its relatively short existence, the Republic of Cuba (1902-1959) was beset by extended waves of political unrest, coups, numerous strikes, and armed clashes between the military and civil groups seeking political change. During this period, the sugar industry was the economy's largest employer and the source of most of Cuba's exports. The sugar industry was dominated by US-based firms, many of which were public companies trading on the New York Stock Exchange. But investments and operations in Cuba were not limited to sugar firms alone – a listing of firms with significant post WWII Cuban operations read like a who's who of American banking and industry from the period.

In this paper, we examine a series of events and actions that took place between November 1956 and April 1961 and trace their impact on the values of 50 US-based firms that ultimately had assets expropriated by Cuba in 1960. We perform a series of joint tests of the Efficient Market Hypothesis (EMH) and the hypothesis that political risk events are relevant to the value of the firms with Cuban exposure. We examine the relationship between responses to political risk events and relative size of the Cuban exposure.

2. Political Risk and Value

It is well known that the present value of a stream of future cash-flows is inversely related to the discount rate applied to the cash-flows. The Capital Asset Pricing Theory¹ posits that the discount rate (R_j) that should be applied to a stream of future cash-flows is equal to: $R_f + B_j(R_m - R_f)$, where R_f is equal to the risk-free rate of return, B_j is the systematic riskiness of the cash-flow stream, and R_m is the return on the market portfolio.

There are two broad views² on how political risk should be incorporated into the CAPM: [1] the political risk premium (PRP) should be added to the so-called 'price of risk' ($R_m - R_f$) before being grossed up or down by the asset's systematic risk measure (B_j) or [2] the political risk premium should be added the asset's expected return (not grossed up by the amount of systematic risk). In either case, the present value of any future cash-flow stream would be negatively (positively) impacted by an increase (decrease) in the political risk premium.

As a result, events³ which lead investors to increase their assessment of the amount of political risk (and thus the premium they demand to bear that risk) would be expected to decrease asset values, separate from the expected

¹ See Sharpe (1964).

² See Butler and Joaquin (1988).

³ See Bruner and Simms (1987), Kim and Mei (2001), Li and Born (2006), and/or Nazir, Younus, and Kaleem (2014) for empirical evidence consistent with this hypothesis.

impact that the event might have the future cash-flow stream.⁴ Conversely, a ‘cooling off’ of political unrest could lead investors to reduce their required political risk premium, which would, in turn, lead to an increase in asset values separate from the expected impact the ‘cooling off’ would be expected to have on size of future cash-flows.

In an informationally efficient capital market, one would expect the market value of publicly traded financial assets to quickly and completely reflect new information. Thus, unexpected ‘events’ which are likely to increase the perception of political risk would be expected to reduce financial asset values quickly to their new expected equilibrium value. In the case where an ‘event’ is partially anticipated, we would expect part of the change in valuation to precede the ultimate occurrence of the ‘event’.

3. Political Instability in 20th Century Caribbean Basin

In the 20th century prior to the outbreak of WWII, relying on the Monroe Doctrine (1823) as justification for military action, the United States sent troops to quell political unrest all around the Caribbean basin (see Table One). In addition to the deployment of the Marines and/or Army troops, the US sent naval forces to demonstrate a show of force to the region on several occasions. However, in 1933 newly elected President Franklin Roosevelt put in place a “Good Neighbor” policy – signaling a shift away the use of military force in order to maintain stability in the region.

Table One: United States Military Intervention in the Caribbean Basin 1900-60

Location	Dates of Military Intervention or Occupation
Cuba	1898-02, 1906-09, 1912, 1917-22
Dominican Republic	1903, 1904, 1914, 1916-24
Haiti	1915-34
Honduras	1903, 1907, 1911, 1912, 1919, 1924, 1925
Mexico	1914, 1916-17
Nicaragua	1912-25, 1926-33

With the onset of the WWII, the US took over English military bases in Antigua, Bahamas, British Guiana, Jamaica, St. Lucia and Trinidad in 1940 in exchange for 50 destroyers. Once a belligerent, the US took over Dutch bases in Aruba and Curacao in 1942. Virtually all the governments in the Western Hemisphere entered the conflict as members of the so-called “Allies” and the region was largely devoid internal political unrest during WWII.

With the end of WWII and the formation of the United Nations, the US gave up its role as (overt) policeman of the Caribbean and sought to achieve its political interests in the region through diplomacy. However, the simultaneous onset of the so-called ‘Cold War’ led the US to be its guard against the possibility of Communist expansion into the Western Hemisphere. Rather than sending the US military to quell civil unrest, the US government relied on the clandestine operations of the Central Intelligence Agency (CIA) to help ensure that governments in the region remained strongly anti-Communist.

While US intervention in the region was usually justified on political stability reasons, there is no denying the fact that US business interests were served / protected by these policies. While US firms could not recover ‘war’ damages through conventional insurance, there was little reason to expect a complete loss due to expropriation. If a government in the Caribbean basin went too far to the political left, it was usually only a matter of time before there was a US-sponsored coup which replaced with regime with one more favorable to US business interests. Against this backdrop we examine capital market responses to political unrest in Cuba in the late 1950s/early 1960s.

4. Political Instability and the Valuation of Companies with Cuban Exposure

We examine the returns to shareholders of a sample of 50 NYSE-listed common stocks of firms, who had operations in Cuba, between November 1956 and April 1961. The beginning of period of analysis corresponds

⁴ While the cash-flows generated in a region with increasing political unrest would no doubt be reduced for most forms of economic activity, there are some activities that might increase during unrest (e.g. the sale of firearms or the provision of security services).

to the clandestine return of Castro and a band of revolutionaries from exile in Mexico. The end of the analysis period is the failed Bay of Pigs invasion of Cuba by US-trained/backed exiles. Table Two reports the average monthly holding period return (HPR) statistics for the full sample and three sub-samples based on the (total asset) relative amount of expropriate loss claims filed for with the Department of Justice.⁵

Table Two: Sample Holding Period Return (HPR) Statistics for 50 US-based firms with Cuban Exposure And three sub-samples based on (total asset) relative Cuban Exposure

	Sample Average HPR Return and t-statistic (n=50)					
Total sample (n = 54 mo.)			-0.0026		-1.165	
Pre-Abdication (n =26 months)			0.0019		0.631	
Castro-Era (n = 28 months)			-0.0069		2.211**	
	Large ¹ (n=13)		Small ² (n=16)		Trivial ³ (n=21)	
	Average HPR and t-statistic		Average HPR and t-statistic		Average HPR and t-statistic	
Total (n=54 mo.)	-0.0096	-1.397	0.0014	0.677	-0.0013	-0.490
Pre-Abdication (n=26)	0.0045	0.542	0.0001	0.032	0.0017	0.042
Castro era (n=28)	-0.0228	-2.210**	0.0026	0.955	-0.0040	1.163

***1% significance level, **5% significance level, *10% significance level

Exposure is defined as (the amount of the firm’s loss claims due to expropriation/firm’s total assets in 1959). ¹Large exposure is a ratio value >5%. ²Small exposure is a ratio >1% but <5%. ³Trivial exposure is a ratio <1%.

Looking across the 54 months, the average HPR for the whole sample was negative, but not significantly different from zero. When we split the sample into a pre- and post-Abdication, we find the sample average HPR was positive (and insignificant) pre-Abdication and negative and significant in the post-Abdication (Castro-Era) period. When we split the sample into portfolios based on their Cuban exposure, we get further clarity. Essentially all the (very) negative average HPRs (-2.28%, significant at the 5% level) were concentrated in the sub-sample of ‘large’ exposure firms after Castro took over.

Over the 54 months covered by this study, the 50 US-based firms with known Cuban exposure were rather volatile and extreme (see Table Three). Volatility grew with relative exposure and for most firms in this sample (38), returns were more volatile following the abdication of Batista. The proportion of monthly that were larger than |10%| (‘extreme’) was larger than is generally observed in CRSP data.

Table Three: US-based Firms with Cuban Exposure*

Number of Monthly Observations, Number of Extremely Positive and Extremely Negative Monthly Returns

All Firms	Monthly Return > 10%	Monthly Return -10%<
Total Months = 2646	246 (9.3% of sample)	127 (4.8% of sample)
Pre-Abdication 1280	121 (9.5% of sample)	40 (3.1% of sample)
Castro-Era 1366	125 (9.2% of sample)	87 (6.4% of sample)

⁵ A total of 8818 claims for losses were registered with the Department of Justice. Of those, 5913 were ruled to be legitimate claims by entities that were at least majority-owned by US citizens or corporations aggregating \$1.9B. Of those, 899 (15%) were by corporations in the amount of \$1.677B (88% of the dollar value). There were 63 firms with claims of \$1M or more, of those, 50 had CRSP return data. The 50 firms in this sample represent \$1.304B (68.4% of all claims, 77.7% of all corporate claims). The 9 largest claims (\$0.994B) are 52.1% of all claims.

Large ¹ Exposure		
Total Months = 668	90 (13.4% of sample)	77 (11.5% of sample)
Pre-Abdication 338	55 (16.3% of sample)	25 (7.4% of sample)
Castro-Era 330	35 (10.6% of sample)	52 (15.8% of sample)
Small ² Exposure		
Total Months = 790	63 (8.0% of sample)	16 (2.1% of sample)
Pre-Abdication 370	21 (5.7% of sample)	4 (1.1% of sample)
Castro-Era 420	42 (10.0% of sample)	12 (2.9% of sample)
Trivial ³ Exposure		
Total Months = 1188	93 (7.8% of sample)	34 (2.9% of sample)
Pre-Abdication 572	45 (7.8% of sample)	11 (1.9% of sample)
Castro-Era 616	48 (7.8% of sample)	23 (3.7% of sample)

*Exposure is defined as (the amount of the firm's loss claims due to expropriation/firm's total assets in 1959). ¹Large exposure is a ratio value >5%. ²Small exposure is a ratio >1% but 5%<. ³Trivial exposure is a ratio 1%<.

We draw attention to 'flip' in the pattern of extreme returns for the portfolio of 'large' exposure firms. In the pre-Abdication period, a large majority of extreme returns were positive, but in the Castro-Era most extreme returns were negative. We note that there was no noticeable change in the pattern of extreme returns for either the 'small' or 'trivial' exposure portfolios. While this is not surprising for the 'trivial' exposure group, it is a little unexpected for the firms with 'small' Cuban exposure – which one might have expected to see experience more negative extreme returns (than observed in the 'trivial' portfolio).

5. Waves of Political Events and the Valuation of Companies Shares with Cuban Exposure

Cuba suffered through a wave of political unrest in the 1930's that, in part, resulted from heavily depressed sugar prices and increasing dictatorial behavior by (then) President Machado. Civil unrest worsened and culminated in the so-called "Sergeant's Coup" led by Fulgencio Batista on 9/5/33. Two short-lived governments later, Batista consolidate his hold on political power and his hand-picked candidate, Carlos Hevia, was named President in January 1934. Shortly thereafter, the US recognized the new Cuban government.

From 1934 until his abdication in 1959, Batista effectively controlled political life in Cuba. During this period, relations with the United States normalized and sugar prices stabilized. In 1940 Batista was elected President of Cuba, in what is deemed a fair election. After one term as President he retired and moved to Florida, but he remained a looming figure over life even in Cuba, even while in absentia.

During WWII, the production of sugar beets in Europe ground to a halt, leading to price increases in refined sugar and a shift to Western Hemisphere-based suppliers. Cuba increased sugar production and enjoyed a rise in exports and incomes through the 1940s and early 1950s. In short, the 18-year period from 1934 to 1952 was a calm period, and the standard of living in Cuba rose substantially – becoming the highest in Latin America (approaching levels being achieved in war-ravaged western Europe).

After nearly eight years residing in Florida, Batista surprises many by returning to Cuba to stand as a Presidential candidate in 1952. When public opinion polls show him running a distant 3rd, Batista engineered a bloodless coup in March 1952 and the US government quickly recognized the government as legitimate. But the return of Batista sparked a new wave of civil unrest. In July 1953, a young Fidel Castro led a disastrous raid against an army installation. He was captured, tried, convicted and sent to prison. As part of a general amnesty in May 1955, Castro was released and exiled to Mexico.

Castro and small group of rebels returned to Cuba to resume their campaign to overthrow the Batista government in November 1956 and soon thereafter they attacked a police station and a government Customs

House in Santiago. Batista (incorrectly) asserted that the Castro brothers had been killed by Army troops that surprised the guerrillas in early December 1956.⁶

We began our empirical analysis the month of Castro's return – November 1956. We ended our analysis in April 1961 with the failed Bay of Pigs 'invasion' by Cuban exiles. In the 54-month sample period there were at least 30 political risk 'events' (in 24 separate months) that occurred in Cuba which had the potential to impact the valuation of US-based firms with Cuban exposure – an average of about one every other month (see Table Four).

Table Four: Potential Cuban Political Risk Events

<u>Date</u>	<u>Event</u>
11/30/1956	After spiriting back into the country, Castro and rebels attack police headquarters and the Custom House in Santiago
12/5/1956	The rebels are ambushed by the Army and Castro barely escapes into the Sierra Madres (Batista incorrectly claims that the Castro brothers were killed in the skirmish) where they begin a guerrilla action against the Batista government
7/30/1957	Santiago's Chief of Police kills Frank Pais, the 23yo local leader of the revolution, his funeral march on 7/31 has 60,000 mourners and the city is shut-down for 3 days
8/15/1957	A wave of arrests made by Batista's police across Cuba
8/20/1957	Castro leads the Rebel Army to victory over the Cuban Army at Palma Mocha
12/6/1957	Rebel forces clash with the Cuban Army at El Salto
3/14/1958	The Eisenhower Administration announces an embargo against the sale of arms to Cuba
4/9/1958	A national general strike does not materialize – a serious setback for the Rebels
5/1958	Cuban government launches "Operation Verano" designed to crush Castro's small but growing Rebel Army. The Army deployed approximately 12,000 soldiers to the Sierra Maestra mountains of southwest Cuba, but 7,000 were new recruits (largely ineffective)
6/29/1958	Outside Santo Domingo the Rebels achieve a significant victory over the Cuban Army
7/11-21/1958	The Cuban Army 'retreat' lures Castro into a trap which, after heavy losses, he negotiates his way out of. The failure of the summer campaign creates a serious moral problem in the Cuban armed forces and makes Batista look weak at home and abroad
9/18/1958	Rebel Army defeats the Cuban Army at Yara
11/3/1958	Batista's hand-picked candidate Andres Aguero is elected President of Cuba
12/9/1958	Rebel Army captures Baire and San Luis
12/15-18/1958	Rebel Army under Che Guevara captures Fomeno
12/29/1958	Che Guevara captures Santa Clara taking almost 3,000 Cuban Army prisoners
1/1/1959	Batista abdicates, reportedly with \$40M, flying to the Dominican Republic before ultimately setting in Portugal. Manuel Urrutia is installed as the interim President.
1/7/1959	Castro arrives in Havana, Eisenhower Administration recognizes the Castro government
2/7/1959	The Cuban Constitution of 1940 is re-instated, fulfilling a promise made by Castro
2/28/1959	Castro announces that elections will be held in two years, giving political parties an opportunity to develop and their programs defined
5/17/1959	Castro signs the Agrarian Reform Act which expropriates farmlands in excess of 1,000 acres and prohibits the ownership of land by non-residents

⁶ Herbert Matthews of the New York Times published a series of articles based on his interviews with Castro in the Sierra Maestra mountains in southeastern Cuba, perhaps the most sensational began on the front page of Sunday edition of the New York Times on 24 February 1957. These articles tended to paint Castro in a rather favorable light and Matthews strongly and repeatedly asserted that Castro was not a communist nor were there communist influences inside the leaders of the 26th of July Movement (as the rebels were known in the mid-1950s)

10/19/1959	Huber Matos resigns as military commander of Camaguey province due to the rising influence of communism in the revolution. He is subsequently arrested for treason
2/6/1960	Soviet Union Deputy Prime Minister Mikoyan begins a visit to Cuba which culminates in a trade agreement whereby the Soviets will buy 5M tons of sugar, while agreeing to provide crude oil, wheat iron, fertilizers, and machinery. Cuba also receives \$100M of import credits from the Soviet Union
6/7/1960	Shell, Esso, and Texaco refuse to refine Soviet crude oil or sell fuel to Cuba
6/29/1960	Cuba nationalizes the Texaco oil refinery. On July 1 Cuba nationalizes Esso and Shell oil refineries
7/3/1960	US Congress passes the “Sugar Act” which eliminated the rest of Cuba’s sugar quota
7/5/1960	Cuba nationalizes all US business and commercial property
9/17/1960	Cuba nationalizes all US banks (including Citi, 1 st National Bank of Boston, and Chase)
10/19/1960	Eisenhower Administration announces an export embargo to Cuba, excepting food and medicine
12/26/1960	Operation Peter Pan, the airlifting Cuban children to Florida to live with relatives begins
4/17-20/1961	CIA-trained and supported Cuban exiles land at the Bay of Pigs on the south coast of Cuba in the hope of starting an uprising that will lead to the overthrow of the Castro Government – it fails miserably

With only month returns available prior to mid-1962, and so many (potential) political risk ‘events’, it is impossible to employ standard ‘event study’ methods to isolate the impact of most of these individual events on the valuation of shares. Tragically, data from the Cuban Stock Exchange is unavailable. Average market-adjusted excess returns and t-statistics for sample of 50 US-based firms with Cuban exposure for the 24 months identified in Table Four are reported in Table Five.

Table Five: Average Market-Adjusted Excess Returns [ER] and t-statistics In Months with Large Political Risk Events for US-based firms (n=50) with Cuban Exposure

Month	Average	
	Excess Return	t-statistic
11/56 Castro lands/attacks Santiago modest damage	0.0166	1.368
12/56 Castro ambushed but escapes	0.0123	1.438
07/57 3-day funeral paralyzes Santiago	-0.0076	-0.965
08/57 Wide-spread arrests of dissidents	0.0067	1.076
12/57 Rebels clash with Army at El Salto	0.0257	3.197***
03/58 Eisenhower Adm. Embargos arm sales to Batista	-0.0107	-1.424
04/58 Nation-wide general strike fizzles	0.0137	1.823*
05/58 Army offensive largely ineffective	-0.0085	-1.307
06/58 Rebels defeat Army at Santo Domingo	-0.0052	-0.792
07/58 Army inflicts heavy casualties/Castro escapes	-0.0136	-1.735*
09/58 Rebels defeat Army at Yaro	-0.0112	-1.215
11/58 Batista’s hand-picked candidate elected Pres.	-0.0128	-1.467
12/58 Rebels defeat Army/capture 4 large cities	0.0100	1.220
01/59 Batista abdicates/US recognizes Castro gov’t	-0.0243	-3.051***
02/59 Constitution of 1940 restored as promised	-0.0120	-1.337

05/59 Agrarian reform/land seizures	-0.0144	-1.185
10/59 Commander Mator resigns charged with treason	-0.0195	-2.095**
02/60 Soviet Trade Agreement – buy 5M tons sugar	0.0048	0.562
06/60 US-owned oil refineries nationalized	-0.0322	-2.562**
07/60 All business/commercial property seized	0.0086	0.853
09/60 All banks nationalized	-0.0141	-1.983*
10/60 US imposes trade embargo with Cuba	0.0360	5.129***
12/60 Operation Peter Pan – airlifting children to US	0.0045	0.503
04/61 Bay of Pigs	-0.0157	-1.862*

***1% significance level, **5% significance level, *10% significance level

Given the different levels of exposure and the types of industries represented by firms in the sample, it isn't surprising that only nine of the 24 months for the entire sample of 50 firms had average market-adjusted returns that were significantly different from zero (three at the 1% level, two at the 5% level, and 4 at the 10% level). The three 'big' events (1% significance) were the December '57 blunting of rebel progress by the Army (positive response), the January '59 abdication of Batista/US recognition of the Castro government (negative response), and the October '60 US imposition of a trade embargo on Cuba (positive response). The direction of the average response for the sample is consistent with the hypothesis that a rise (fall) in political risk leads to price declines (rises)/negative (positive) returns.

Next, we placed firms into one of three sub-samples based on the firm's relative *exposure* in Cuba which was defined as the firm's claim for expropriation losses (as reported to the US Justice Department) divided the firm's total assets at the end of fiscal 1959 (which for majority of firms was December). We somewhat arbitrarily describe a firm's exposure as 'trivial' if its ratio of loss/total assets was less than 1%. There were 21 firms in the 'trivial' sub-sample and their average exposure was 0.47%.

We split the remaining firms into two groups, along the lines of a naturally occurring break in the distribution of the relative Cuban exposure measure (claimed loss/total assets). Firms with exposure greater than 1% but less than 5% are described as having 'small' exposure (n=16) and those with a measure greater than 10% (including firms with claims larger than 100%⁷ of their total assets) as having "large" exposure (n=13). The 'large' group of 13 firms had an average exposure measure of 69.2%⁸ and the 'small' group of 16 firms had an average exposure of 2.6%.

When we re-examine the 24 months when (potential) political risk events occurred, by sub-samples we get a very different view of the Cuban experience (see Table Six). For the group of 'large' exposure firms, 12 of the 24 months have average market-adjusted returns significantly different from zero. Four of the averages were significant at the 1% level: 11/57 (negative – when the tide was turning toward the rebels), 5/59 (negative – land seizures), 6/60 (negative – oil refineries nationalized) and 5/60 (positive – US trade embargo put in place).

Table Six: Average Market-Adjusted Excess Returns [ER] and t-statistics In Months with Large Political Risk Events for Portfolios of US-based firms with Large, Small, and Trivial exposure

Month	Average		Average		Average	
	Excess Return /	t-statistic	Excess Return /	t-statistic	Excess Return /	t-statistic
	Large ¹ (n=13)		Small ² (n=16)		Trivial ³ (n=21)	
November 1956	0.0876	2.587**	-0.0235	-2.341**	0.0013	0.070
December 1956	0.0245	0.947	-0.0005	-0.039	0.0137	1.438

⁷ Some firms included a discounted value of future expected profits as part of their loss claim. There was not a standard methodology required by the Justice Department (and not all claims for lost future profits were certified), so discount rates and time horizons varied across claimants.

⁸ Seven of the firms had their assets expropriated, and four made claims in excess of total assets. In those cases, the exposure ratio was limited to 100%.

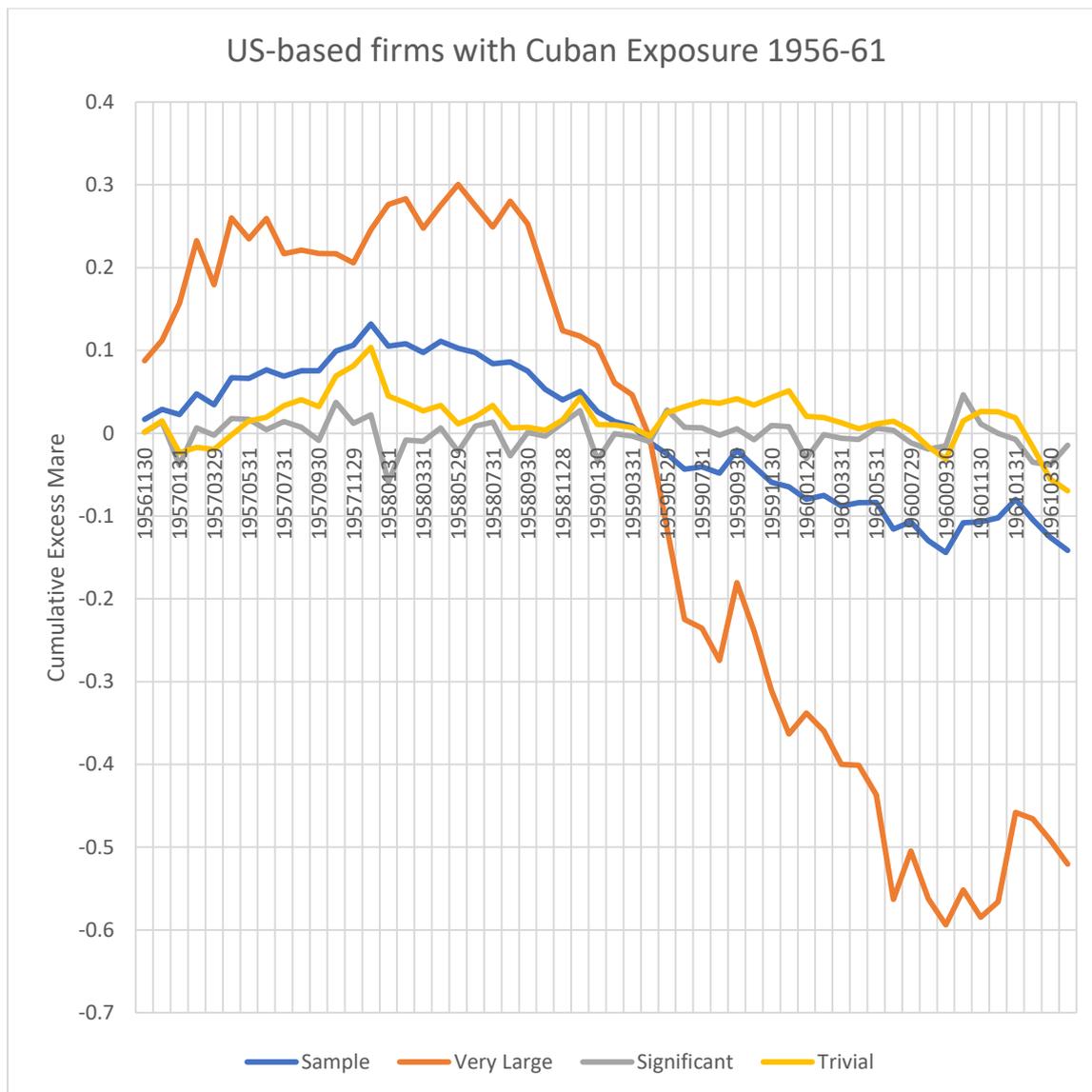
July 1957	-0.0427	-1.841*	-0.0078	-1.141	0.0142	1.196
August 1957	0.0046	0.257	0.0080	1.370	0.0071	0.645
December 1957	0.0402	1.927*	0.0179	1.662	0.0224	1.734*
March 1958	-0.0358	-1.565	0.0094	0.916	-0.0095	-0.966
April 1958	0.0258	1.546	0.0116	1.202	0.0066	0.466
May 1958	0.0256	1.866*	-0.0186	-1.873*	-0.0224	-2.513**
June 1958	-0.0257	-1.566	-0.0069	-0.714	0.0088	0.918
July 1958	-0.0259	-2.113*	-0.0392	-3.476***	0.0136	1.077
September 1958	-0.0275	-1.332	-0.0133	-0.846	0.0008	0.064
November 1958	-0.0637	-4.272***	-0.0045	-0.261	0.0122	1.007
December 1958	-0.0067	-0.358	0.0011	0.107	0.0272	2.001*
January 1959	-0.0122	-0.715	-0.0236	-1.865*	0.0324	2.458*
February 1959	-0.0444	-1.934*	-0.0008	-0.053	-0.0005	-0.041
May 1959	-0.1100	-6.004***	0.0071	0.379	0.0283	1.535
October 1959	-0.0582	-2.430**	-0.0032	-0.242	-0.0080	-0.510
February 1960	-0.0218	-1.276	0.0349	2.785**	-0.0017	-0.125
June 1960	-0.1261	-4.127***	-0.0086	-0.667	0.0034	0.174
July 1960	0.0583	1.975*	-0.0021	-0.185	-0.0116	-0.899
September 1960	-0.0313	-1.573	0.0002	0.014	-0.0152	-1.635
October 1960	0.0422	3.356***	0.0180	1.245	0.0467	4.797***
December 1960	0.0187	0.806	0.0020	0.142	-0.0002	-0.017
April 1961	-0.0291	-2.003*	-0.0124	-0.875	-0.0146	-0.996
Average (n=54 mo.)	-0.0096	-1.397	0.0014	0.677	-0.0013	-0.490
Pre-Abdication (n=26)	0.0045	0.542	0.0001	0.032	0.0017	0.042
Castro era (n=28)	-0.0228	-2.210**	0.0026	0.955	-0.0040	1.163

***1% significance level, **5% significance level, *10% significance level

¹Large exposure is a loss ratio value >5%. ²Small exposure is a loss ratio >1% but 5%<. ³Trivial exposure is a loss ratio 1%<.

The direction of shareholder responses to these four ‘big’ events is consistent with the predictions of the political risk premium model. We cumulated the average monthly market-adjusted excess returns (CER) for the full sample and the three sub-samples and the full sample and present them in Figure One. What stands out is that the CER for the ‘large’ exposure portfolio was very positive from November 1956 through August 1958 (CER = +28%) – much higher than the ‘small’ exposure portfolio (CER = +3%) or the ‘trivial’ exposure portfolio (CER < +1%). This corresponds to a time period when the outcome of the “26th of July Movement” (as the rebels referred to themselves) uprising was in doubt.

After the blunting of the Army offensive in July of 1958, the rebels began an offensive campaign of their own in August 1958. While success initially came slowly, the rebellion gained momentum and in less than five months the rebels were riding into Havana after Batista fled to the Dominican Republic with a reported \$40 million in gold on New Year’s Eve 1958. The pattern of CERs for the ‘large’ exposure portfolio mirrored the decline of Batista. Post-abdication, the CER decline continued as Castro’s policies evolved from socialistic to communistic/confiscatory.



There were not many individual months that had average market-adjusted returns significantly different from zero for either the ‘small’ or ‘trivial’ sub-samples. The sub-sample with ‘small’ Cuban exposure had a very negative average market-adjusted return that was significant at the 1% level in 5/57, the month the Army inflicted large casualties on the rebels, but Castro escaped. The only months that the ‘trivial’ exposure sub-sample had an average market-adjusted return that was significant (negative) at the 1% in 5/58 (the launch of Operation Verano) and 10/60 (when the Cuban government nationalized all banks).

6. Summary and conclusion

After nearly two decades of relative stability, Batista engineered his second coup and returned to power in 1952. In response, civil unrest returned to Cuba. Beginning in late 1956, the average value of the sampled firms with Cuban exposure trended up, as the outcome of the rebellion was anything but certain. However, the blunting of the Army’s summer offensive against the rebels in July 1958 signaled a turning point in the rebellion. Beginning in August 1958, shareholder returns began to turn negative – especially for the sub-sample of firms with a ‘very large’ Cuban exposure.

Batista’s abdication on New Year’s Day 1959 was a virtual non-event for firms with a ‘very large’ exposure, but it was a negative jolt for firms with a ‘small’ exposure. Interestingly, firms with a ‘trivial’ exposure responded very positively to change in regimes. However, once in power Castro’s drift toward communism was associated with extremely negative returns, especially by shareholders of firms with ‘very large’ Cuban exposures.

About the only respite from the downturn for the shareholders of the firms with ‘large’ exposures were US government actions to suspend the Cuban sugar quota and then to impose a trade embargo. Although not highly

significant (10% level), shareholders of firms with 'large' exposure experienced negative returns when the Bay of Pigs 'invasion' failed. The market recognized that covert action was not going to restore the pre-Castro status quo and the Kennedy administration balked at spending US troops. In short, the expropriation losses were going to be 'permanent'.

For the most part, the rise of Castro and subsequent expropriation of business and commercial assets was a non-event for the shareholders of firms that had avoided making (relatively) large investments in Cuba. We interpret these results as consistent with the hypothesis that the 'losses' from expropriation are rare and that they are an acceptable cost of doing business in economies with elevated political risk (relative to the US).⁹ We conclude that US securities markets were remarkably effective in processing the stream of sometimes confusing information coming out of Cuba in the late 1950s and early 1960s.

References

- Bruner, Robert and John Simms, "," *Journal of Money, Banking and Credit* 19 no. 1 (Feb 1987), p. 46-55.
- Butler, Kirt C. and Domingo Castelo Joaquin, "A Note on Political Risk and the Required Return on Foreign Direct Investment," *Journal of International Business Studies* 29 no. 3 (3rd Quarter 1988), p. 599-608.
- Cuervo-Cazurra, Alvaro and Luis Alfanso Dau, "Promarket Reforms and Firm Profitability in Developing Countries," *The Academy of Management Journal* 52 no. 6 (Dec 2009), p. 1348-68.
- Fama, Eugene, Lawrence Fisher, Michael Jensen and Richard Roll, "The Adjustment of Stock Prices to New Information," *International Economic Review* 10 no. 1 (Feb 1969), p. 1-21.
- Gott, Richard. *Cuba: a new history* (Yale University Press: New Haven) 2004
- Kim, Harold and Jianping Mei, "What makes the stock market jump? An analysis of political risk on Hong Kong stock returns," *Journal of International Money and Finance* 20 no. 7 (Dec 2001), p. 1003-16.
- Li, Jinliang and Jeffery A. Born, "Presidential Election Uncertainty and Common Stock Returns in the United States," *Journal of Financial Research* 29 no. 4 (Winter 2006): 609-622.
- Matthews, Herbert, "Cuban Rebel is Visited in Hideout," *New York Times* (24 Feb 1957), p. 1
- Nazir, N. Sajid, Hassan Younus, and Ahmed Kaleem, "Impact of political events on stock returns: empirical evidence from Pakistan" *Journal of Economics and Administrative Sciences* 30 no. 1 (May 2014), p. 60-78.
- Sharpe, William, "Capital Asset Prices: A theory of market equilibrium under conditions of risk," *Journal of Finance* 19 no. 3 (Sept 1964), p. 425-442.
- Timeline of Cuban history, Wikipedia (https://en.wikipedia.org/wiki/Timeline_of_Cuban_history)
- Welch, Richard E. "Herbert L. Matthews and the Cuban Revolution," *The Historian* 47 no. 1 (Nov 1984), p. 1-18

Author

Jeffery A. Born

Professor of Finance / Associate Dean for Undergraduate Education, Finance Group, D'Amore-McKim School of Business, Northeastern University, USA, j.born@neu.edu

⁹ While the evidence is empirical evidence is mixed, there is a belief that the developing world offers growth and/or profit opportunities unavailable to firm in developed economies like the US. See Cuervo-Cazurra and Dau (2009) for a discussion and contemporary evidence.