The effect of firm-level political risk on risky corporate financial assets

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Abstract

This study investigates how firm-level political risk influences corporate investment in risky financial assets. Analyzing hand-collected data from annual reports of S&P 1500 non-financial firms over the period of 2009–2022, we find that heightened political risk significantly reduces firms' risky asset holdings, supporting the precautionary motive. Additionally, positive political sentiment and topic-specific uncertainties notably affect the financial investment decisions. Our findings contribute to the literature by explicitly differentiating financial asset types and providing nuanced insights into firm-level political dynamics influencing financial asset allocation.

JEL classification: G30

Keywords: Cash holdings; Corporate financial assets; Political risk; Risky financial assets; Precautionary motive

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Abstract

This study investigates how firm-level political risk influences corporate investment in risky financial assets. Analyzing hand-collected data from annual reports of S&P 1500 non-financial firms over the period of 2009–2022, we find that heightened political risk significantly reduces firms' risky asset holdings, supporting the precautionary motive. Additionally, positive political sentiment and topic-specific uncertainties notably affect the financial investment decisions. Our findings contribute to the literature by explicitly differentiating financial asset types and providing nuanced insights into firm-level political dynamics influencing financial asset allocation.

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1. Introduction

Corporate liquidity management, particularly firms' motivations for holding cash, has been extensively explored in prior literature. Keynes (1936) categorizes cash holdings primarily into transactional, precautionary, or speculative motives. Subsequent research identifies precautionary, agency, and tax motives as key determinants of firms' cash-holding decisions, consistently emphasizing the precautionary motive as firms hedge against future liquidity shortfalls (Opler et al., 1999; Bates et al., 2009; Almeida et al., 2004).

Recent studies have expanded this perspective by distinguishing explicitly between safe and risky financial assets in corporate portfolios. Almeida et al. (2014) critique conventional financial asset measurements, highlighting significant underestimations when relying solely on databases like Compustat. Duchin et al. (2017) address this issue by manually collecting detailed data from corporate disclosures, uncovering substantial investments in risky financial assets such as corporate bonds and equities. Darmouni and Mota (2024) further document the recent rise in corporate bond holdings to levels comparable to traditional cash-like instruments. Reinforcing these findings, Chen and Duchin (2022) and Huang and Sachetto (2025) argue that such risk-taking in financial asset allocation aligns broadly with firms' precautionary motives.

Simultaneously, the impact of political risk on corporate decision-making has garnered increasing attention. Previous studies highlight how political instability influences stock market behavior (Brogaard et al., 2019; Fan et al., 2008), investment choices (Julio & Yook, 2012), and the management of cash reserves (Xu et al., 2016). However, most research has measured political risk using macro-level indicators, such as election-year dummies. In contrast, Hassan et al. (2019) introduced a firm-level political risk measure based on textual

analysis of quarterly earnings call transcripts. They demonstrate that firm-specific political risk significantly outweighs broader macroeconomic uncertainties, primarily due to localized policy changes and regulatory shocks. Extending this line of research, this paper investigates the relationship between firm-level political risk and investment in risky financial assets. We hypothesize that firms exposed to higher political risk reduce their allocation to risky financial assets, consistent with the precautionary motive.

This study empirically tests the influence of firm-level political risk on corporate investment in risky financial assets. Utilizing manually collected fair-value data from 10-K footnotes for S&P 1500 non-financial firms from 2009 to 2022, we classify financial assets into safe (cash and equivalents, U.S. Treasuries, agency debts) and risky categories (corporate bonds and equities). Our analysis confirms prior findings (Duchin et al., 2017), showing that firms with considerable financial assets invest more heavily in risky financial assets. Crucially, we provide robust evidence indicating that firms facing elevated political risks significantly reduce their risky financial asset holdings, supporting the precautionary motive.

Additionally, using two-stage least squares (2SLS) regression based on Azzimonti's (2018) partisan conflict index as an instrumental variable, we examine the relation between the firms' political sentiment and their holdings of risky financial assets. We find that positive firm-level political sentiment enhances investment in risky financial assets. Further, we document that specific political risks related to economic, environmental, health, tax, and technological factors negatively affect such investment decisions. These results validate the negative relationship between political risk and risky financial asset allocation.

This paper contributes to existing literature by emphasizing the significant influence of firm-level political risk on corporate financial asset composition, a relatively

underexplored area. Alam et al. (2025) report increased cash holdings during periods of high state-level economic policy uncertainty. Similarly, Hasan et al. (2022) observe higher cash holdings among firms with greater exposure to firm-level political risk. However, these studies primarily investigate safer financial assets such as cash and short-term investments. Our study adds crucial evidence indicating that heightened firm-level political risk prompts firms to decrease their holdings of risky financial assets while increasing allocations to safer assets. Moreover, we further elucidate how political sentiment and nuanced, topic-specific political uncertainties distinctly shape corporate financial asset allocation decisions.

2. Data

We utilize a sample comprising non-financial firms listed in the S&P 1500 index, covering the period from 2009 to 2022. The conventional approach in research on corporate cash holdings typically involves using the "cash and equivalents" (*CHE*) item from the Compustat database. However, Almeida et al. (2014) argue that the cash values reported in Compustat do not accurately reflect the true magnitude of a firm's financial assets. To address this issue, we manually collected detailed information regarding financial assets from the footnotes of annual reports (10-K filings), accessible through the Securities and Exchange Commission's EDGAR database, following methodologies outlined by Duchin et al. (2017) and Darmouni and Mota (2024). Specifically, we extracted data on the fair values of cash and equivalents, U.S. Treasury and agency debt, U.S. corporate debt, foreign corporate debt, U.S. equity, foreign equity, asset-backed securities and mortgage-backed securities, other debts, foreign government debt, and miscellaneous assets. We then categorize cash and equivalents, along with U.S. Treasury and agency debt, as safe assets, whereas all other financial assets are classified as risky.

We integrate this financial asset data with firm-level political risk metrics developed by Hassan et al. (2019). These metrics employ machine-learning algorithms to differentiate political from non-political discussions within corporate earnings calls. Specifically, they identify "bigrams"—pairs of frequently co-occurring words commonly associated with political contexts—and measure the frequency with which these bigrams appear alongside terms indicative of "risk" or "uncertainty." The frequency of each bigram is weighted according to term frequency and normalized by the total length of each conference call, thus producing a measure of political risk (*PRisk*). Additionally, Hassan et al. (2019) develop a measure of political sentiment (*PSentiment*) by adjusting their algorithm to capture bigrams occurring with positive or negative tone words. We utilize these measures to explore how firm-level political risk influences the composition of corporate financial assets.

Table 1 presents descriptive statistics for the variables employed in our analyses. To mitigate the influence of outliers, all variables are winsorized at the 1st and 99th percentiles. The mean (median) value of financial assets relative to total assets is 15.7% (10.3%), demonstrating a right-skewed distribution. Further decomposition reveals that, on average, risky assets constitute only 9.3% of total financial assets, with a median value of 0%, indicating that approximately half of the firms in our sample hold no risky financial assets. Mean values for *PRisk* and *PSentiment* are 5.466 and 0.008, respectively. For regression analysis controls, firm-specific accounting data are obtained from Compustat, including market-to-book asset ratios, firm size (natural logarithm of total assets), return on assets (ROA), net working capital (NWC), capital expenditures, R&D expenditures, long-term debt, and dividends. These control variables, except firm size and market-to-book ratios, are scaled

by total assets.[1]

<Insert Table 1 about here>

3. Empirical findings

Prior to conducting baseline regression analyses, we validate the reliability of our manually collected data by replicating models established in previous literature. Regressions (1) and (2) in Table 2 replicate Opler et al. (1999)'s methodology, examining relationships between cash holdings and various firm characteristics. Regression (1) uses cash and equivalents, including short-term investments, while Regression (2) employs financial assets as dependent variables. Results indicate consistency with previous findings derived from Compustat data. Additionally, the result from of regression (3) confirms that firms with greater financial asset holdings tend to allocate a higher proportion to risky assets, aligning with Duchin et al. (2017).

<Insert Table 2 about here>

To investigate the relation between a firm's risky financial asset and political risk, we estimate the following baseline regression model:

$$Risky\ Financial\ Asset_{i,t} = \alpha + \beta_1 PRisk_{i,t} + \beta_2 (control\ variables)_{i,t}$$

$$+\beta_2 \sum (firm\ fixed\ effects)_{\ i} + \beta_3 \sum (year\ fixed\ effects)_{\ t} + \varepsilon_{i,t}$$

The dependent variable is risky financial assets scaled by total financial assets, and the main explanatory variable is the measure firm-level political risk developed by Hassan et al. (2019). We include financial assets, return on assets, market to book ratio, firm size, net

[1] The definition of all variables is provided in Appendix.

working capital, capital expenditure, R&D expenditure, long-term debt, and a dummy variable indicating dividend-paying firms as control variables.

Table 3 presents the estimation results of baseline regression model. In regression (1), we find that the coefficient on our main explanatory variable, *PRisk*, is not statistically significant. This finding might be related to the fact that roughly 50% of the firms hold exclusively safe assets as shown in Table 1. We thus introduce a dummy variable (*FA_high*) that identifies firms with above-median financial asset holdings. Regression (2) uses the interaction term between *FA_high* and *PRisk* as the key independent variable. The negative and statistically significant coefficient of this interaction term (at the 1% level) coupled with the insignificant standalone coefficient of *PRisk* indicates that firms with greater financial assets generally hold more risky assets but reduce such holdings under heightened political risk. Subsequent analyses focus on the subset of sub-sample firms with above-median financial assets. The result of regression (3), which re-estimate the baseline model, confirms that *PRisk* negatively and significantly affects risky financial asset holdings, supporting the precautionary motive hypothesis.

<Insert Table 3 about here>

In additional analyses, we substitute *PRisk* with political sentiment (*PSentiment*) as a measure of firm-level political risk, also developed by Hassan et al. (2019). To address potential endogeneity problems, we employ a two-stage least squares (2SLS) model using the partisan conflict index (*PCI*) developed by Azzimonti (2018) as an instrument variable, reporting the results in Table 4. The first-stage regression indicates a significantly positive relation between *PCI* and *PSentiment*. We then find that the coefficient on the fitted *PSentiment* is positive and significant at 1% confidence level in the second-stage regression.

The findings suggest that firms with a more favorable political sentiment on the issues of partisan conflicts are inclined to hold riskier financial assets.

<Insert Table 4 about here>

Finally, we investigate the impact of topic-specific political uncertainties on firms' risky asset holdings, as presented in Table 5. Our findings indicate that political uncertainties related specifically to economic, environmental, health, tax, and technological issues significantly discourage risky financial asset holdings.

<Insert Table 5 about here>

4. Conclusion

Our study contributes to the literature on corporate liquidity management by underscoring the pivotal role that firm-level political risk plays in shaping corporate investment decisions, particularly regarding the composition of financial assets. By explicitly categorizing financial assets into safe and risky assets and employing a nuanced, firm-specific measure of political risk, we document that heightened political risk prompts firms to adopt a more conservative stance, reducing their exposure to riskier financial assets. Our findings are consistent with the precautionary motive, highlighting the strategic adjustments firms make in response to political uncertainty. Additionally, positive political sentiment encourages increased investment in risky financial assets, indicating firms' strategic responsiveness to favorable political environments. Topic-specific analyses further reveal that uncertainties related to economic, environmental, health, tax, and technological factors substantially deter risky financial investments. These insights offer valuable implications for understanding corporate risk management behaviors in politically uncertain environments.

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Appendix. Variable Description

Variable	Description
Financial Asset (FA)	Total fair values of the financial asset classes hand-collected from the 10-K footnote scaled by total assets (TA)
Safe Financial Asset (SFA)	Safe financial assets (cash (CH) from COMPUSTAT + U.S treasury and agency debt) scaled by total financial assets
Risky Financial Asset (RFA)	Risky financial assets (Total financial assets - safe financial assets) scaled by total financial assets
Political Risk (*PRisk*)	Firm-level political risk developed by Hassan et al (2019). The authors construct a firm-level political risk measure by analyzing the text of quarterly earnings call transcripts. They compute the frequency of politically relevant bigrams identified using training data from political and nonpolitical texts that appear in proximity to terms like "risk" or "uncertainty." This frequency, scaled by the total length of the transcript, captures the extent of political risk discussed by the firm at a given time.
Political Sentiment (*PSentiment*)	Firm-level political sentiment index developed by Hassan et al (2019). The authors develop a measure of political sentiment by adjusting the original algorithm to identify political bigrams that co-occur with positive or negative tone words. This allows the authors to distinguish between favorable and unfavorable political discussions, which are shown to relate to firm-level outcomes.
Partisan Conflict Index (PCI)	Macro-level partisan conflict index developed by Azzimonti (2018) The author constructs an index of partisan conflict in the U.S. by analyzing newspaper articles that report political disagreement over government policy, both within and across parties. Using semantic search techniques in Factiva, the monthly index is calculated as the frequency of such articles, normalized by the total number of news articles in 1990.
Market to book	[Total asset (TA) – Total Common Equity (CEQ) + Market Capitalization (CSHO * PRCC_F)] scaled by total assets (TA)
Firm size	Natural log of total assets (TA)
Return on assets	Earnings before interest (EBITDA) scaled by total assets (TA)
Net working capital (NWC)	[Total current asset (ACT) – Total current liabilities (LCT)] scaled by total assets (TA)
Capital Expenditure	Capital expenditure (CAPX) scaled by total assets (TA)
R&D Expenditure	R&D expenditure (XRD) scaled by total assets (TA)
Long-term debt	[Debt in current liabilities (DLC)+ Long-term Debt (DLTT)] scaled by total assets (TA)
Dividend	Cash dividend (DVC) scaled by total assets (TA)

Table 1. Descriptive statistics

The table presents the number of observations (N), mean, median, standard deviation (SD), minimum (Min), and maximum (Max) of key variables for the full sample. The variables are defined in Appendix.

Full Sample	Obs	Mean	Median	SD	Min	Max
Financial Asset	13,639	0.157	0.103	0.158	0.002	0.707
Risky Financial Asset	13,639	0.093	0.000	0.180	0.000	0.799
Safe Financial Asset	13,639	0.907	1.000	0.180	0.201	1.000
PRisk	13,639	5.466	5.622	1.265	0.000	9.258
PSentiment	13,639	0.008	-0.062	1.003	-6.311	8.199
Market to book	13,639	2.208	1.747	1.457	0.788	9.012
Firm size	13,639	8.043	7.881	1.543	5.073	12.132
Return on assets	13,639	0.152	0.139	0.096	-0.107	0.492
NWC	13,639	0.206	0.181	0.182	-0.140	0.705
Capital Expenditure	13,639	0.042	0.029	0.040	0.003	0.231
R&D Expenditure	13,639	0.029	0.004	0.047	0.000	0.234
Long-term debt	13,639	0.257	0.243	0.194	0.000	0.882
Dividend	13,639	0.017	0.006	0.026	0.000	0.148

Table 2. Regression results

The table presents the regression results on three dependent variables: cash and equivalents (including short-term investments) divided by total assets (CHE/AT) in regression (1), financial assets divided by total assets (FA/AT) in regression (2), and risky financial assets divided by financial assets (RFA/FA) in regression 3. The variables are defined in Table Appendix. The *t*-statistics reported in parentheses are based heteroscedasticity-robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)
VARIABLES	Cash and equivalents	FA	RFA
FA			0.410***
			(9.594)
Return on assets	-0.004	0.010	-0.042*
	(-0.337)	(0.676)	(-1.849)
Market to book	0.003**	0.002	-0.001
	(2.371)	(1.415)	(-0.369)
Capital expenditure	-0.207***	-0.222***	0.229***
	(-6.785)	(-6.259)	(3.310)
Long-term debt	0.037***	0.015	-0.059***
	(4.122)	(1.299)	(-3.164)
Dummy for dividend	-0.006**	-0.008**	0.009
	(-2.232)	(-2.327)	(1.481)
Firm size	-0.010***	-0.014***	0.008
	(-3.148)	(-3.498)	(1.207)
NWC	0.677***	0.604***	-0.184***
	(43.926)	(32.515)	(-5.023)
R&D expenditure	0.013	-0.059	-0.052
	(0.154)	(-0.566)	(-0.364)
Constant	0.092***	0.151***	0.010
	(3.457)	(4.631)	(0.173)
Observations	13,520	13,520	13,520
R-squared	0.922	0.901	0.734
Firm FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Cluster	Firm	Firm	Firm

Table 3. Relation between risky financial assets and political risk

The table presents regression results on risky financial assets, the main explanatory variable is political risk and the interaction term in between. Regression (1) and (2) are estimated using the full sample. Regression (3) is estimated using the sub-sample of firm-years with financial assets of more than the median. The variables are defined in Appendix. The *t*-statistics reported in parentheses are based heteroscedasticity-robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)
VARIABLES	RFA	RFA	RFA
FA	0.410***		0.445***
	(9.595)		(8.822)
PRisk	-0.001	0.001	-0.003**
	(-0.725)	(1.106)	(-2.106)
Dummy for FA_high		0.045***	
		(4.266)	
Interaction between FA_high & PRisk		-0.004**	
		(-2.456)	
Return on assets	-0.042*	-0.040	-0.062*
	(-1.851)	(-1.619)	(-1.727)
Market to book	-0.001	-0.000	-0.001
	(-0.380)	(-0.149)	(-0.428)
Capital expenditure	0.229***	0.152**	0.271**
	(3.306)	(2.177)	(2.381)
Long-term debt	-0.059***	-0.051**	-0.094***
	(-3.163)	(-2.530)	(-3.065)
Dummy for dividend	0.009	0.006	0.020**
	(1.484)	(0.959)	(2.180)
Firm size	0.008	0.004	0.016
	(1.207)	(0.498)	(1.292)
NWC	-0.184***	0.032	-0.261***
	(-5.024)	(0.985)	(-5.404)
R&D expenditure	-0.053	-0.101	-0.094
	(-0.365)	(-0.624)	(-0.612)
Constant	0.014	0.053	0.011
	(0.241)	(0.889)	(0.112)
Observations	13,520	13,520	6,565
R-squared	0.734	0.723	0.789
Firm FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Cluster	Firm	Firm	Firm

Table 4. Relation between risky financial assets and political sentiment

The table presents 2SLS regression results. Model (1) and (2) are estimated using the sub-sample of firm-years with financial assets of more than the median. The variables are defined in Appendix. The *t*-statistics reported in parentheses are based heteroscedasticity-robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

	(1) 2SLS (1st stage)	(2) 2SLS (2ND stage)
VARIABLES	PSentiment	RFA
Psentiment		0.037***
		(3.635)
PCI	0.001***	
	(17.527)	
FA	0.241	0.639***
	(1.188)	(11.275)
Return on assets	0.318	-0.110**
	(1.428)	(-2.206)
Market to book	0.048***	-0.005
	(3.209)	(-1.455)
Capital expenditure	-1.414**	0.440**
	(-2.294)	(2.513)
Long-term debt	-0.445***	-0.098***
	(-3.576)	(-3.488)
Dummy for dividend	-0.138***	0.008
	(-2.720)	(0.696)
Firm size	0.064***	0.023***
	(3.324)	(5.019)
NWC	-0.726***	-0.153***
	(-4.183)	(-3.189)
R&D expenditure	-0.620	0.481***
	(-1.274)	(3.908)
Constant	-1.350***	-0.158***
	(-8.083)	(-4.130)
Observations	6,820	6,820
R-squared	0.080	0.199
Firm FE	No	No
Year FE	No	No
Cluster	Firm	Firm

Table 5. Relation between risky financial assets and topic-based political risk

The table presents the regression results using 8 different topic-based political risks. These political risks are economic, environmental, trade, institution, health, security, tax, and technology related political risks. The variables are defined in Appendix. The *t*-statistics reported in parentheses are based heteroscedasticity-robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
VARIABLES	RFA	RFA	RFA	RFA	RFA	RFA	RFA	RFA
PRisk_economic	-0.003**							
	(-2.142)							
PRisk_environment		-0.002**						
		(-2.013)						
PRisk_trade			-0.002					
			(-1.371)					
PRisk_institutions				-0.001				
				(-0.628)				
PRisk_health					-0.002**			
					(-2.025)			
PRisk_security						-0.002		
						(-1.609)		
PRisk_tax							-0.003**	
							(-2.157)	
PRisk_technology								-0.003**
								(-2.522)
Constant	0.016	0.011	0.005	-0.001	0.012	0.009	0.014	0.016
	(0.158)	(0.115)	(0.047)	(-0.006)	(0.122)	(0.095)	(0.139)	(0.162)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	6,565	6,565	6,565	6,565	6,565	6,565	6,565	6,565
R-squared	0.789	0.789	0.789	0.789	0.789	0.789	0.789	0.789
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Cluster	Firm	Firm	Firm	Firm	Firm	Firm	Firm	Firm