

Putting Too Much Stock in Your Company – A 401(k) Problem



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With major Enron and Worldcom trials completed or in the works, stories of employees losing some or all their retirement income are back in the news. Now is a good time to ask yourself if you hold too much of your retirement nest egg in your employer's stock.

NASD is issuing this Alert because it is concerned that employees who have the opportunity to invest in company stock may be concentrating too much of their retirement savings in a single security. NASD is particularly concerned about employees who have all or most of their 401(k) assets in their employer's stock. If the stock takes a beating, so does your retirement savings.

No Restrictions Can Lead to High-Risk Investing

Currently, there are no restrictions on the amount of 401(k) assets that can be held in company stock. While the Employee Retirement Income Security Act of 1974 (ERISA), restricts traditional pension plans (also known as defined benefit plans) from investing more than 10% of assets in company stock, there is no similar restriction on 401(k) plans.

Employees can direct a high percentage of their contributions to company stock, even if they are given other investment options. Employer-matched contributions often come in the form of company stock, further concentrating holdings in employer stock. A study by the Employee Benefits Research Institute and the Investment Company Institute found that employees who have the opportunity to do so held more than 25% of 401(k) assets in company stock. In the case of employees over the age of 60, almost 25% held more than half their 401(k) savings in their employer's stock. Even more startling, 16% of employees over the age of 60 held more than 80% of their 401(k) savings in company stock. The result: a non-diversified retirement portfolio that hinges to a large extent on the performance of a single stock.

Learning from History?

The fall of Enron Corporation focused attention on the potentially devastating effect of owning too much company stock. 57.73% of employees' 401(k) assets were invested in Enron stock as it fell 98.8% in value during 2001. But employees at many companies still have even larger percentages of their 401(k) assets in company stock than Enron employees did.

What Could Go Wrong If You Concentrate Retirement Savings in Company Stock?

Simply stated, if you put too many eggs in one basket, you can expose yourself to significant risk.

In financial terms, you are under-diversified: you have too much of your holdings tied to a single investment—your company's stock. Investing heavily in company stock may seem like a good thing when your company and its stock are doing well. But many companies experience fluctuations in both operational performance and stock price. Not only do you expose yourself to the risk that the stock market as a whole could flounder, but you take on a lot of company risk, the risk that an individual firm—your company—will falter or fail.

Restrictions Can Limit Liquidity

There's another potential problem with concentrating too much of your savings in company stock. Your company may place restrictions on your ability to buy or sell the stock, or transfer it to another type of investment within your 401(k). This limits the control you have on your finances.

Employer-matched stock, in particular, often comes with restrictions. Some companies require employees to hold the stock until they reach a certain age, or until a specified date. This can spell trouble. If the stock slides, you may be stuck on the sidelines without the ability to sell and limit your losses.

Lockdowns or blackouts can also occur. These are periods in which account activity is frozen, generally to perform administrative tasks. Usually lockdowns are for a short duration (a few days to a few weeks), with employees given advance notice. Nonetheless, it's possible that a lockdown could coincide with a slide in company stock. This happened at Enron, when the stock declined more than 35% during a pre-scheduled two-week blackout.

How Much is Too Much?

The general consensus among financial experts is that an adequately diversified portfolio should have no more than 10 to 20% of total investment assets in company stock. If you concentrate much more than that in company stock, especially in a 401(k) plan where there are trading restrictions, you may expose yourself to more company risk that it is wise to incur. Of course, there is no single formula or percentage that suits all investors, so you should consult a professional about what the right mix of investments is for you.

If you are one of the 8 million participants in 401(k) plans who have more than 20% of assets in company stock, and this investment also constitutes more than 20% of your

overall investment portfolio, you may want to consider re-balancing your investments to increase diversification.

What is Diversification?

Diversification is an investment strategy for spreading your principal among different markets, sectors, industries, and securities. The goal is to protect the value of your overall portfolio in case a single security or market sector takes a serious downturn and drops in price. In short, diversification spreads your risk, while still seeking a strong return on overall investment. NASD's Smart 401(k) Investing learning center has additional information about diversification and rebalancing your portfolio.

Take Control of Your Financial Future

To achieve appropriate diversification, employees with company stock should consider doing the following:

- Determine your total exposure to company stock. Be sure to include stock options, pension plans, employee-directed stock purchases and company matches in your total. You may have additional exposure to your company's stock through mutual funds in which your company is part of the investment mix. Many investors didn't know how fully exposed they were to technology and Internet stocks until the bubble burst in 2000 and they saw declines not only in their individual stock holdings, but in mutual funds that had investments in these same companies. If your company stock holdings exceed 20% of the value of your total investment portfolio, you may wish to consider redistributing your assets across a broader spectrum of investment.
- Know the restrictions, if any, on buying and selling company stock. The more of your portfolio you have tied up in company stock with restrictions, the more risk you incur.
- Read your company's key SEC filings, including annual reports (10-K), quarterly reports (10-Q) and reports of material events (8-K).
- Use metrics such as beta—a measure of the volatility of a stock relative to an overall market index during a given time period—to evaluate the level of risk your company's stock carries. Employees whose company stock is subject to significant volatility or whose company scores high on other risk measures should be particularly wary of investing too large a percentage of their investments in company stock.
- Read analyst reports and other information from third-party sources to evaluate the short and long-term prospects of your company's stock performance. Don't rely solely on your employer's advice or guidance for why you should invest in company stock.

- Maintain reasonable expectations of the performance of your company's stock. Striking it rich is hard to do, no matter how dominant or successful a company is. All companies, even the most successful, have their ups and downs.

It's Your Retirement

Owning company stock does allow employees to share in the financial success of a company. But it also carries the risk that a company's financial problems will become the employee's financial problems. When it comes to investing for retirement, it's you, not your employer, whose financial security ultimately is at risk from overexposure to company stock.

In determining how much you should invest in company stock remember that your retirement is just that—yours!

Resources

For additional information on saving for retirement, read NASD's Smart 401(k) Investing.

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