Company Stock in 401(k) Plans Concerns Securities Regulator

A securities regulator has issued a regulatory alert to investors, cautioning them of its "concern" that employees have concentrated too much of their retirement savings in a single security - their own company stock.

Why has the National Association of Securities Dealers (NASD) issued this alert? Currently, there are no restrictions on the amount of 401(k) assets that employees can hold in their company stock. Compare that freedom to the 10% limit that ERISA places upon traditional pension plans. The problem is compounded by the fact that employers often match employee 401(k) contributions by way of company stock.

Company stock concentration can lead to large investment losses. The NASD cites the Enron 401(k) debacle as an example. At that company, nearly 58% of the employee's 401(k) assets were invested in Enron stock. That stock fell almost 99% in value in one year, 2001.

Indeed, a study by the Employee Benefit Research Institute contains several findings that the NASD cites with concern. The statistics show that, on average, employees hold more than 25% of their 401(k) assets in company stock. More disturbing, 25% of employees over the age of 60 hold more than 50% of their 401(k) assets in company stock. "Even more startling", says the NASD, the study shows that 16% of employees over the age of 60 hold more than 80% of their 401(k) assets in company stock. The numbers are staggering. The NASD writes that 8 million 401(k) participants have more than 20% of their assets in company stock.

The problem further is compounded because a company may place restrictions on an employee's ability to sell or transfer the stock. For example, with some employer-matched stock, the employee may be required to hold the stock until he or she reaches a certain age or until a certain date. That is the case with Pfizer stock. Pfizer plan participants cannot diversify out of company-matched stock until age 55, when they are allowed to move 50% of their balance in the fund. Likewise, there may be "lockdowns" or "blackouts", during which all account activity is frozen. The NASD reports that this happened with Enron employees, who watched their Enron stock lose 35% of its value in just a two week blackout period.

So, stock concentration, coupled with sale / transfer restrictions, presents a great risk of loss for investors' retirement assets. According to the NASD alert, 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."

How can 401(k) employees reduce their risk of loss? Diversify. Employees should be able to diversify into other asset classes, such as bond mutual funds, money market funds and Guaranteed Investment Contracts (GICs) or other stable value funds. Even diversifying into other stocks, through equity mutual funds and balanced mutual funds, reduces the concentration problem.

Upon retirement, employees can roll over their 401(k) assets to a financial adviser. At that point, additional solutions become available. For example, the retiree may sell the company position and purchase other individual stocks or individual bonds. Moreover, if the retiree chooses to maintain the concentrated position in his former employer's company stock, the financial adviser can, and should, recommend appropriate hedging techniques. These would include selling covered calls as well as buying puts, or a combination of the two. For substantial amounts of company stock, additional

techniques include over-the-counter equity collars and prepaid forwards, as well as contributing the shares of the concentrated stock position to an "exchange fund", which is a private equity investment that is professional managed to mirror the performance of a broad-based market index of another investment objective.

As always, avoid placing "all of your eggs in one basket", even if those eggs are the stock of the company that employs you!

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