



Company Stock in 401(k) Plans Can Be Damaging: John F. Wasik

By John F. Wasik

June 4 (Bloomberg) -- Company stock held within 401(k)s is like a bull in a china shop: A lot of damage can be done in a short amount of time.

Midyear is ideal to gauge retirement-plan risk and make some changes. Company-stock ownership is a suitable place to start your review.

Even if you think your employer represents the best investment in the world, you are focusing risk in one security, which is perilous. You count on your employer for salary and benefits. You needn't put your retirement on the line as well.

The epic failures of WorldCom Inc. and Enron Corp. -- where thousands of employees held company stock that became virtually worthless in their 401(k)s -- haven't stopped millions of workers from counting their employer's shares as the biggest holding.

Employees who can do so without restrictions hold more than 25 percent of their 401(k)s in company stock, according to a survey by the Employee Benefit Research Institute, a Washington-based organization.

The risk of owning stock doesn't necessarily decrease the longer you hold it, and there's no guarantee it won't plummet just before you retire.

8 Million Workers

In the survey, 25 percent of those older than 60 held more than half their retirement plan in employer stock. That's asking for trouble. It would be almost impossible to rebuild your retirement kitty at that age if those shares tanked.

Almost 60 percent of Enron employee assets were invested in the stock when the company lost most of its value in 2001 and eventually filed for bankruptcy. Even with new protections built into last year's Pension Protection Act, Congress didn't prohibit employers from offering company stock in 401(k)s, nor did it take away their tax break for doing so.

Yet workers have an emotional bind to their employer and they consistently believe that their company will always prosper. That might explain why more than 8 million workers have more than 20 percent invested in employer stock.

The financial reasons for avoiding company shares in 401(k)s are strong. The emotional connection is more powerful.

Corporate Loyalty

Research in behavioral economics consistently shows that all too often we think we have an advantage over others when buying stocks and then hold on much too long even if the share price drops. That's because the prospect of taking a loss is more painful than admitting that it's time to sell.

The NASD, the securities industry's regulator, warned in a 2005 Investor Alert that ``an adequately diversified portfolio should have no more than 10 percent to 20 percent of total investment assets in company stock. You may want to consider rebalancing your investments to increase diversification."

What if you feel that selling company stock would show disloyalty to your employer?

``The Enron collapse woke most people up," says Sheryl Garrett, a certified financial planner with the Garrett Planning Network Inc. in Shawnee Mission, Kansas. ``No amount of kissing up to your employer is worth your financial future."

One way of easing out of company stock is to send a "fiduciary letter" to the head of your investment committee or chief financial officer requesting that 401(k) contributions not be invested in the employer's stock.

Michael Dubis, a fee-only financial planner in Madison, Wisconsin, has suggested this tactic for his clients whose 401(k) contributions are placed into company shares.

Tax Benefits

A short draft would read: "Company stock subjects employees to concentrated individual stock risk; human-capital risk as it relates to having both employment and assets in one place; and it is not a sound fiduciary standard for diversification prudence that trustees of the plan must adhere to." Since you have already invested human capital in your job, over-investing in company shares adds another layer of unnecessary risk.

If you want to own employer stock, it's probably best to hold it in a taxable brokerage account in relatively small quantities. That way, if it collapses, you can at least write off the losses against taxable income.

"At least in a brokerage account, if it's a gain, you can gift the stock for charitable donations without paying tax on the gains or to your children for college expenses -- assuming the child is at least 18 and in a low capital-gains rate," says [Barry Kaplan](#), a certified financial planner with Cambridge Southern Financial Advisors in Atlanta.

"In a 401(k) or individual retirement account, the gain becomes ordinary income, and the loss can never be taken. But if held outside of an IRA or 401(k), you can take that 15 percent rate on gains or actually take a loss against other investment income."

What to Do

If company stock represents more than 20 percent of your net worth, it's time to sell some of it. What do you buy with the proceeds?

-- Consider Real Estate Investment Trusts, or mutual funds that invest in a variety of them. As companies that buy commercial real estate, their income-rich returns don't track stocks closely and offer you diversification.

-- A diversified bond fund such as the Ishares Lehman Aggregate Bond Fund. It invests in the lion's share of the U.S. bond market and has a low 0.2 percent annual expense ratio. This is a staple in my 401(k).

-- Non-U.S. stocks give you protection against the dollar dropping in value, plus capital appreciation and dividends. The Vanguard Total International Stock Market Index Fund is also in my 401(k) plan, covering European, Pacific and emerging markets.

Even if Wall Street and your fellow employees concur that your company has a sunny future, keep one thing in mind: Like the weather, the future of stocks is something that nobody can predict in the long term. And one storm can cause huge damage.

(John F. Wasik, author of "The Merchant of Power," is a Bloomberg News columnist. The opinions expressed are his own.)

To contact the writer of this column: John F. Wasik in Chicago at jwasik@bloomberg.net.

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