Is There an Enron in Your Retirement? (Palo Alto Weekly, Dec. 26, 2001)

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Loading your 401(k) with employer's stock can be risky business

No fallout from the Enron debacle is more distressing on a human level than that of Enron workers having their retirement savings wiped out or sharply reduced by the collapse of Enron stock. The 11,000 employees who participated in the stock-heavy Enron 401(k) saw the plan lose an estimated $1 billion in value (60 percent of the total) as Enron shares plunged from $80 to less than $1. Enron workers will also face losses on pensions, not just 401(k)'s, and many face unemployment in a depressed labor market.

True, those employees should have diversified by putting more of their 401(k) savings into other investment alternatives available to them. One could say they were greedy, seduced by the glitter of Enron's once-highflying stock.

But such employees were being loyal to the company and wanted their own small share of the riches that Enron executives habitually pocketed. By one estimate, over the past three years Enron executives pocketed more than $1 billion by dumping shares acquired through stock options and other compensation.

The Enron collapse highlights a hazard of some 401(k) retirement plans: loading company stock into employee 401(k) accounts. Nationwide, six million of the nation's 40 million 401(k) plan participants partake in those accounts, with the stock valued at perhaps hundreds of billions of dollars.

It's tempting to buy company stock for those accounts. Many big firms, including Enron, offer stock on the cheap by matching part of what the employee purchases. But some plans can be a one-way street, with employees virtually compelled to buy stock yet forbidden to sell stock even when the price plummets.

Companies reap big benefits by loading stock into their employee 401(k) plans. Stock ownership is believed to spur employees to work harder. Employers get a tax deduction in the amount of the company contribution and, if that contribution is made in stock, it costs the firm nothing in cash.

Also, 401(k) accounts loaded with company stock means many shares in friendly hands. Companies that prevent employees from selling until a certain age or leaving the firm altogether are keeping a big source of selling pressure from hitting the shares during tough times.

Enron prevented employees from selling shares accumulated with company contributions until they reached age 50. Although this did not save Enron stock from collapse, it did major harm to workers. Lawsuits have already been filed, but in a corporate bankruptcy, holders of common stock wait at the end of the creditor line.

Enron is not alone in its age requirement for the sale of company stock. Other large firms – such as Coca-Cola, Gillette, International Paper, and Proctor & Gamble – have age restrictions on the sale of 401(k) company stock.

An "Enron-like" 401(k) meltdown has also occurred at Lucent Technologies. Lucent cut 30,000 jobs this year, and many of those displaced workers had invested a significant portion of their retirement resources in company stock – in some cases, all in Lucent shares. Lucent stock declined 91 percent between 1999 and 2001, which means that many of those who lost their jobs have also seen devastating declines in their retirement holdings. The only reason there has been little media coverage of this disaster is because it has taken place over a longer period of time.

It's strange but true that no rule requires companies overseeing their employees' 401(k) plans to offer sensible, prudent investment diversification for their employees. Roughly one-third to one-half of retirement assets at large companies are invested in company stock. A more diversified 401(k) plan might have a dozen or more investment choices – including a range of stock, bond and money-market funds – with no more than perhaps 10 to 15 percent invested in company stock.

Lurking behind 401(k) disasters lies a sea change in America's retirement system. Just two decades ago most workers were in "defined benefit" plans – that is, they were promised a fixed pension by their employers, and employers bore the risk of meeting those pension obligations. Today the risk has shifted from employer to employee. Most workers now have "defined contribution" or "self-directed" plans: they invest retirement funds and accept the risk that those investments might go bad. Some employees seek investment advice but many try to be "do-it-yourselfers."

In theory, defined contribution plans are attractive. Retirement contributions are normally subsidized in part by the employer and receive tax-sheltered treatment. Employees can choose how much to save (within legal limits) and how to invest their money. More choice is usually beneficial.

But the plight of Enron and Lucent employees highlights the stark contrast between theory and practice. On the one hand, employees have been cajoled by their employers and by bull-market barkers into holding a high proportion of their retirement assets in company stock. The exploitation of such financial incest was typified by rules that apparently allowed Enron executives to unload the dropping stock while employees could not.

On the other hand, the big shift away from old-fashioned pensions has coincided with an enormous bull market. Many workers had not seen stock prices fall precipitously since becoming investors, and underestimated the real risk of losing money. Prudent long-term management of a self-directed retirement account is a subject not everyone can master on a part-time basis.

We all hope that Enron-like corporate collapses will not become commonplace. However, millions of Americans have had, or will have, "near-Enron" experiences: watching to their dismay as their retirement savings shrivel or evaporate. Then they're left dependent on the one big defined-benefit program that remains: Social Security. If Social Security is still around, that is.

Some believe Social Security is going to be converted to a defined-contribution plan because the financial industry – which has enormous political clout – stands to gain so much from the conversion. If that comes to pass, the fate of Enron's employees – victims of a management they believed to be on their side – could be the spectre of things to come.

Do everything you can to educate yourself about how to protect the hard-earned dollars in your 401(k) or other retirement programs. Seek qualified advice and practice prudent diversification of your retirement funds. Your financial security in retirement may well depend on steps you take today.