401(K) PLANS & COMPANY STOCK: HOW MUCH SHOULD YOU RETAIN?

By Albert J. Zdenek Jr.

Even if your company's stock is hot, you can have too much of a good thing if you overweight your investment portfolio so that the employer's stock is your largest holding.

Many people who work for large, publicly traded companies are given the option to purchase company stock through their 401(k) plans. Some companies further encourage employees to purchase company stock in 401(k) savings plans by offering a match with employee contributions. And many companies lure middle and upper management to stay with them by rewarding them through non-qualified and incentive stock option plans.

As a result, it is not difficult for investors working at these companies to wind up with a large percentage of their investment holdings in the equity of their employer.

The effect has been compounded in the most recent long-running bull market where large-cap stocks continue to shine—in this environment, more 401(k) investors are likely to stay put and ride their company's stock rather than take the time to research the market for other investment possibilities.

But even if someone's company stock is currently hot, can the investor have too much of a good thing?

The answer is "yes" if they overweight their investment portfolio so that the employer's stock is their largest holding.

Poor diversification can result in a much higher-risk portfolio than the investor intended. Further, the older an investor becomes (and therefore the shorter their investment horizon), the more risky a portfolio top-heavy in a single stock becomes.

Retirement, being one of the key financial turning points in an investor's life, is an important time to reevaluate one's basket of investment holdings and determine if there is a wiser allocation to make for this new stage of life.

But if it's tough for the investor as an employee to sell off some shares of company stock, it's even more difficult as a retiree. To many individuals, the company stock has become an "old friend" in the portfolio, and particularly with the long bull market, it most likely has risen a great amount. There is an emotional attachment to the stock, and an understandable desire to not miss any further upward performance.

Typically, a soon-to-be-retiree faces two big investment decisions:

- Should 401(k) plan holdings stay put in the employer's plan, or be withdrawn to invest anew in an IRA? and
- How much money in the stock of the former employer is too much?

BILL AND HELEN

To examine how you may want to address these issues, let's take the case of Bill and Helen Thomas, who now face these two questions.

Bill is about to retire from a large publicly traded company, where he has worked for the past 21 years. Recently, the human resources department at Bill's company has notified him that he must let the company know if he

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TABLE 1. BILL'S 401(K) INVESTMENTS

Investment	Amount ($)	Percent of 401(k) (%)
Company Stock	350,000	56
Large-Cap Fund	100,000	16
International Fund	100,000	16
Long-Term Corporate Bond Fund	75,000	12
Totals	**625,000**	**100**

plans to leave his 401(k) assets in the company plan, or withdraw them. This prompts Helen and Bill to re-examine their investment holdings and asset allocations so that they can then decide what action to take.

The Thomases' assets include investment holdings that total $855,000 (in Bill's 401(k) plan and their personal investment portfolio, and Bill's vested portion in his company's traditional pension plan):

- *Pension Plan Assets*: Bill is fully vested in the company pension plan, which, come retirement, will begin paying out $3,500 on a monthly basis for the rest of his life. If Helen turns out to be the surviving spouse, Bill has chosen the pension option that will pay Helen $3,000 for the rest of her life. (For more on survivor options, see "Pension Distributions: What's the Right Option for You?" by Stephen Craffen in the June 1999 issue of the *AAII Journal*.)
- *401(k) Assets*: The Thomases have taken full advantage of Bill's 401(k) plan over the years and have accumulated $625,000 in assets. The 401(k) plan's offerings included a choice of company stock (where purchases are commission-free) and seven mutual funds, each in a different style category. Table 1 indicates how Bill's 401(k) assets are invested.
- *Personal Investment Assets*: The Thomases own their home, having paid off their mortgage. They also have personal taxable savings of $230,000 (See Table 2).

INVESTMENT ASSETS

The Thomases are ready to address the first question: Should 401(k) plan holdings stay put in the employer's plan, or be withdrawn to invest anew in an IRA?

The underlying decision the Thomases face is in choosing who is in charge of a significant part of their financial destiny: themselves or Bill's soon-to-be former employer.

Option 1: Let the company continue to hold Bill's 401(k) investments. There are pros and cons to leaving one's 401(k) assets in a company plan.

On the upside: This is the easiest option for the Thomases. It requires little or no work or thought on their part, and they save a lot of time—no dealing with CPAs, lawyers, financial planners or investment advisors, and no struggling with having to make another choice. The Thomases will draw from Bill's 401(k) assets, as needed, to supplement their monthly income needs.

On the downside: Leaving Bill's 401(k) assets in the company plan might cost the Thomases a lot of income generation and wealth preservation during their retirement years. In addition, keeping Bill's 401(k) with his company will provide the Thomases with few investment choices. Most companies offer a limited choice of mutual funds to participants in 401(k) plans. Typically, there is one fund per investment type (e.g., large-cap equity, small-cap equity, etc.), making for around six to eight total choices. There are over 10,000 mutual funds in existence today, run by portfolio managers who follow different investment styles and approaches. Additionally, there are thousands of individual securities in the stock and bond markets in which one can invest. So, an offering of six to eight mutual fund investment options is a very limited choice indeed for assembling a portfolio that aims for a specific investment return and risk exposure.

Suppose the Thomases wish to increase risk exposure in their investment portfolio in order to improve their chances for greater returns, but the 401(k) plan does not offer such an investment. Keeping Bill's 401(k) assets in the company plan restricts their options.

Leaving the 401(k) plan assets in the hands of Bill's employer also limits the Thomases' estate planning options. Eventually, Bill and Helen will pass away. The survivor will have access to the 401(k) funds, but upon the survivor's death, the choice of how to pay the remainder of the 401(k) to the heirs may be limited.

So, while the balance of the 401(k) will pass to the heirs, it will have to be distributed in a lump sum to them. As a result, the heirs will not get the benefit of tax deferral on the growth of the funds. Also, other valuable options for payments to the Thomases and their beneficiaries will be lost. Paying capital gains

TABLE 2. THE THOMASES' OTHER INVESTMENT ASSETS

Investments	Amount ($)	Percent of Personal Assets (%)
Company Stock	115,000	50
Certificates of Deposit	59,800	26
Helen's IRA (in a large-cap fund)	27,600	12
Money Market Fund	27,600	12
Totals	**230,000**	**100**

TABLE 3. 401(K) OPTIONS UPON RETIREMENT

OPTIONS	PROS	CONS
Option 1: Leave 401(k) with employer	• Less time and effort required	• Limited choice of investments • Limited influence over portfolio risk • Limited tax and estate options
Option 2: Take control of assets by rolling over into an IRA	• More investment choices • Potential for better investment returns • More influence over investment risk • More control over tax and estate planning options	• More personal participation needed • More investment knowledge required

taxes on the future growth of the company stock taken out of the 401(k) instead of tax on ordinary income and obvious options such as converting the 401(k) funds to a Roth IRA will not be available.

Option 2: Roll over Bill's 401(k) assets into their own IRAs. There are pros and cons to taking over one's 401(k) assets from a company plan.

On the upside: More investment options will give the Thomases more possibilities to create more wealth for themselves and their heirs.

Should Bill and Helen choose to increase risk to their portfolio for the potential reward of greater return, they will have more control in doing so. As a result, they may be able to create more cash flow for their retirement than if investment choices were restricted. This may allow the Thomases to better weather emergency demands for additional cash flow.

In addition, more tax and estate planning opportunities will be available. For example, when Bill passes away, Helen will have more choices on how to control the payout of the IRA with the rolled over 401(k) assets than if the money remained in the 401(k). She will be able to exercise elections on the minimum payments out of the IRA. Having the choice of converting to a Roth IRA may allow her to save on income taxes as well as leave the remainder of the Roth IRA estate tax free to heirs.

On the downside: This option demands more thought, choices and ongoing participation by the Thomases, so choosing option two results in more complexities. This option will also involve more paperwork, since Bill is going to have to set up a traditional IRA in which to roll the 401(k) proceeds. The Thomases may even want to hire an investment advisor or tax or estate planning professional to help them analyze their situation. Table 3 summarizes the pros and cons of the Thomases' options.

THE 401(K) DECISION

Bill and Helen tally the pros and cons of their two options and decide that they are too limited by the investment choices offered through the company 401(k) program. Although the plan covers many of the same asset categories they wish to invest in, they prefer to make their own fund selections rather than using the funds selected by Bill's employer. For that reason, they decide to roll over Bill's 401(k) into an IRA.

Now, the Thomases are ready to address the second question: How much money in the stock of Bill's former employer is too much?

The underlying issue for the Thomases is how much money in any one stock is too much?

Table 4 shows the Thomases' current total portfolio and how it is allocated. You can see from the table that over 50% of their retirement portfolio—401(k) and personal investment holdings—is invested in company stock.

The company stock has done very well in the bull market, and Bill has been with his employer a great part of his adult life. For him, it feels wrong to sell it. However, it is obvious that their portfolio contains too much risk by having such a large

TABLE 4. TOTAL PORTFOLIO HOLDINGS BEFORE COMPANY STOCK DECISION

Investment	Bill's Rollover IRA ($)	Helen's IRA ($)	Personal Taxable Portfolio ($)	Total ($)	Total (%)
Company Stock	350,000	—	115,000	465,000	54.4
Large-Cap Fund(s)	100,000	27,600	—	127,600	14.9
Small-Cap Fund(s)	—	—	—	—	—
International Fund(s)	100,000	—	—	100,000	11.7
Long-Term Corp Bond Fund	75,000	—	—	75,000	8.8
Inter. Corp. Bond Fund	—	—	—	—	—
High-Yield Bond Fund	—	—	—	—	—
Certificates of Deposit	—	—	59,800	59,800	7.0
Money Market	—	—	27,600	27,600	3.2
Totals				**855,000**	**100.0**

TABLE 5. TOTAL PORTFOLIO HOLDINGS AFTER COMPANY STOCK DECISION

Investment	Bill's Rollover IRA ($)	Helen's IRA ($)	Personal Taxable Portfolio ($)	Total ($)	Total (%)
Company Stock	—	—	43,000	43,000	5.0
Large-Cap Fund(s)	230,000	27,600	—	257,600	30.1
Small-Cap Fund(s)	175,000	—	—	175,000	20.5
International Fund(s)	100,000	—	—	100,000	11.7
Long-Term Corp. Bond Fund	75,000	—	—	75,000	8.8
Inter. Corp. Bond Fund	—	—	72,000	72,000	8.4
High-Yield Bond Fund	45,000	—	—	45,000	5.3
Certificates of Deposit	—	—	59,800	59,800	7.0
Money Market	—	—	27,600	27,600	3.2
Totals				**855,000**	**100.0**

position in one equity. As long as the stock of the company does well, the Thomases will be all right, but history tells us that sooner or later prices also trend down for certain time periods, particularly with single stocks. Or worse, the company could face a stretch of reduced profitability, or even go out of business. This would leave the Thomases with a greatly reduced retirement portfolio and a much lower retirement income.

A good rule-of-thumb is to hold no more than 5% of a portfolio in any one stock. That would prevent the specific business problems of any one company or industry from having too much influence on the retirement portfolio, and it allows for adequate diversification among various stocks, significantly reducing risk.

If the Thomases diversify out of the company stock and into other investments, they can better structure their retirement portfolio to match their risk tolerance and long-term investment return needs that will allow them to sustain the level of retirement income they want for the rest of their lives.

The Thomases have decided that their large holding in the stock of Bill's employer exposes them to greater downside risk than they are comfortable with, so they decide to sell some off.

Table 5 shows their holdings after their sale. The Thomases decided to retain 5% of their portfolio in company stock because they feel that the company's prospects are still good. They shifted all of the 401(k) money out of company stock (now in a rollover IRA), and kept their 5% holdings in their taxable portfolio. This is the most tax-efficient approach, since it minimizes the taxes that must be paid on any gains from the stock.

With the proceeds of the company stock sold from their taxable portfolio, the Thomases purchased shares in an intermediate-term bond fund. With the proceeds of the company stock sold from the 401(k), the Thomases added to their large-company stock fund, and purchased shares in a small-company stock fund and a high-yield bond fund. Except for the company stock, the highest-returning assets are kept in the Thomases' IRAs, so that they can get maximum benefits out of tax-deferral.

The stock portion of the resulting investment portfolio, with the new commitment to small-cap stocks, remains aggressively invested, but is balanced by the greater commitment to a diversified portfolio of large-cap stocks. The addition of a high-yield bond fund diversifies the interest rate risk in the fixed-income portion of the portfolio and increases the possibility of higher (although more volatile) returns. While the restructured portfolio has only a slightly lower commitment to equities than previously, the level of risk is greatly reduced because the portfolio is much more diversified.

Although a lot more work was involved, by taking control of their investments and diversifying their investment portfolio, the Thomases greatly reduced their downside investment risk and did not lose any potential for gain. In contrast, had they chosen not to take charge of their finances and done nothing to rebalance their portfolio, the Thomases, in the long run, might have had to pay a dear price for taking what some might perceive as the "easy route." ✦