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Too Much Company Stock? Diversification begins at the office

Imagine this introductory conversation between a 52 year-old executive at a large corporation and his newly hired investment advisor:

Advisor: Tell me about your portfolio.

Executive: About \$800,000 in my Schwab account. Mostly stock funds. Some bonds. Some money market.

Advisor: What stocks?

Executive: All passively managed mutual funds. Very diversified. Large cap, small cap, growth, value, emerging markets.

Advisor: What else?

Executive: Well, I have company stock too.

Advisor: How much?

Executive: All of my 401k, plus some more. About \$600,000 altogether.

Advisor: Okay. That's quite a bit in one company. Have you thought about reducing that? Diversifying more?

Executive: Well, I work there. I want to keep that stock. It's a great company.

This is an imaginary discussion, but the dilemma is a real one for many investors – a high concentration of assets in their employer's stock in an otherwise well-diversified portfolio.

Based on loyalty to the employer, overconfidence in the company's future, or simple inertia, it is sometimes easier to hold onto company stock than to sell it. Furthermore, if the stock has appreciated strongly or was purchased at below market cost through stock options, a big tax bill on capital gains may be waiting when shares are sold.

Double danger

Being invested in the results of one's employer seems like an obvious virtue, but it comes at a risk. Holding a big stake in any single stock is risky. One negative surprise – real or perceived – can send a company's stock price tumbling. A failed product, lawsuit, industrial accident, harsh analyst commentary, product recall, breakthrough by a competitor, or scandal of any flavor can cut a company's market value in half overnight. Or worse.

But that's only half of the hazard. When a company's stock slides fast, it is often a result of – or the cause of – other calamities, including layoffs, restructurings, divestitures, plant closings, product line



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cuts, or outsourcing. In the extreme, of course, a company may be sold, enter bankruptcy, or simply close its doors.

Major disruptions like these can mean lost jobs, creating the risk of a double danger – a shrinking portfolio and the loss of employment.

The role of the 401k

401k plans can drive up employee stock holdings. At businesses where company stock is offered as an asset allocation option, 20.5 percent of 401k assets are invested that way. And nearly 7 percent of participants in those plans have more than 80 percent of their account balances invested in company stock, according to an October 2009 report from the Employee Benefit Research Institute.ⁱ

The result can be rough. Consider the infamous implosion of one of the 1990's highest flying companies, the energy firm Enron. At Enron, more than 57 percent of employees' 401(k) assets in 2001 were invested in company stock as it fell 98.8 percent in value that year.ⁱⁱ Five thousand jobs disappeared too.

Likewise, employees at Lehman Brothers, Bear Stearns, Washington Mutual, General Motors and many other companies were left holding significant stakes in their companies during the very dark days of 2008. By the time the scope of the financial crisis became clear, stock prices were plummeting; it was too late to sell. Then the other shoe dropped; thousands lost their jobs.

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The worst outcome for an investment, of course, is complete loss of value, as in a bankruptcy. While individual companies can and do go bankrupt, it is very unlikely that a diversified portfolio of hundreds or thousands of holdings could ever collapse to zero.

When emotion gets into the equation

Investing is technically complex, but psychology and emotion play big roles too. The way investors look at money, investments, and financial plans can lead to portfolio situations they might otherwise rigorously seek to avoid. Here are some mindsets that can cause trouble:

This stock is special. When individuals receive stock from their employer, through a gift, or via inheritance, it is often treated as separate from the rest of a portfolio. Keeping a distinct account for this special stock is fine, but treating it differently – especially as “sacred” and unsalable – can lead to dangerous overconcentrations. In the end, the source of funds or securities should have no bearing on how they are invested.

I work here. Shares of company stock can hold emotional value in addition to monetary value. Selling them can feel like treason, but the investor's first responsibility is to his or her family and financial future. Ignoring the need for diversification – one of prudent investing's most fundamental principles – for the sake of corporate loyalty can be a costly mistake.

It could never happen to me. No one expects a worst-case disaster with his or her employer – neither via a falling stock price nor a lost job. But thousands of laid off workers today will tell you that anything is possible. No matter how unlikely, this is a kind of risk that can be avoided, and should be.



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The taxes on my gains are too high. When company stock has appreciated, contributing a portion of the gains to the IRS can be a tough pill to swallow. Nonetheless, the benefit of increasing diversification is often worth it. An investment advisor can often reduce the tax on gains by using tax mitigation strategies.

Do you own too much?

It is easy to accumulate company stock, and often difficult to let it go. Still, paring down employer stock holdings clearly reduces risk associated with unpredictable events that may affect the company. It can also eliminate an unintended overweighting in that stock's asset class.

Avoiding the double risk of a falling stock price and job loss – no matter how unlikely it may be – should be high on the priority list for all investors. A first step toward this goal is an unemotional review of your portfolio – determining the true level of exposure to your employer's fortunes.

ⁱ "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008," By Jack VanDerhei, EBRI; Sarah Holden, ICI; and Luis Alonso, EBRI; Employee Benefit Research Institute; October, 2009. www.ebri.org

ⁱⁱ "Putting Too Much Stock in Your Company—A 401(k) Problem," FINRA.org (Financial Industry Regulatory Authority)

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