Topic 6: What is a 401(k) and what is the impact of Enron’s bankruptcy on its employee 401(k) plan? Using hindsight, what should the employees have done in terms of putting together a retirement investment strategy?

A 401(k) is a tax-deferred investment and savings plan that acts as a personal pension fund for employees. The name refers to the relevant section in the tax code. This plan lets you defer taxes on a portion of your salary until you retire. You pay taxes on your investment gains when you withdraw money from the plan, which you can begin doing without penalty at age 59½. When you leave a company, you can roll over funds into your new employer’s 401(k) or into an IRA. You must start withdrawing funds after age 70½. Part of what makes this plan such a powerful retirement vehicle is that many employers match employee contributions, usually in the range of 15% to 50%. Plan participants usually have a choice of investments, including stocks, bonds, and fixed income funds. Some employers restrict investments to their own company’s stock. Many 401(k) plans allow you to borrow from your nest egg. Generally, you must pay back the loan within five years, but you may owe a 10% penalty and taxes if you haven’t paid the money back when you leave the company. The law allows you to make early withdrawals in certain cases of economic hardship, but you will get caught by the 10% penalty unless you are disabled, you leave your company at age 55 or later, or you need the money for
medical expenses exceeding 7.5% of your adjusted gross income. Any employee can sign up for a company’s 401(k). Contributions are automatically deducted from your paycheck. While your own contributions always belong to you, you may have to wait a few years to be fully vested in the company.

There are six essential 401(k) plan functions. They are design, administration, record keeping, investment, communication with employees and cost control. The key elements in 401(k) design are deciding how the employer's 401(k) contributions should be allocated among employees and in determining the employer's 401(k) matching contributions. A proper employer match can increase employee participation in the 401(k) plan and may help meet certain 401(k) nondiscrimination requirements, thus reducing total employer contributions. Selection of appropriate eligibility requirements and a vesting schedule will also affect employer contributions. Proper 401(k) administration requires a determination of necessary administrative services to keep the 401(k) in compliance. Competent, cost-effective 401(k) consultants or service organizations must be selected to provide these services and their performance must be monitored. Nondiscrimination testing is one area that demands special expertise. It is important that 401(k) monies be properly allocated to participants' accounts. Failure to do so can distort participant balances and endanger the tax status of the 401(k) plan. 401(k) investments can be pooled or participant-directed. If participant-directed accounts are selected, an employer may reduce fiduciary responsibility for investment losses if the requirements are met. Forming an investment committee, appointing an investment manager or adviser and monitoring investment earnings and other measures may help reduce employer liability in this area. Though 401(k) employee communication is
important to help meet certain reporting and disclosure requirements, convincing employees to participate is integral for the 401(k) plan's success. If employees are shown how the 401(k) arrangement can help them save for retirement and defer taxes, their appreciation of the program should lead to greater participation. The employer should provide investment information and education but not advice, even though the line between them may be blurry. Controlling 401(k) plan costs requires that employers consider expenses relating to establishing and maintaining the 401(k) in addition to the 401(k) contributions themselves. Negotiating with the organizations providing 401(k) services, switching to other 401(k) service providers, performing tasks in-house, or shifting assessments to employees are general approaches that can help reduce costs. Employers can directly decrease their costs by reducing their 401(k) contributions.

There are few 401(k) plans that are as heavily invested in company stock or have restrictions on the sale of company stock as the Enron plan did. Enron’s 401(k) plan was so heavily weighted with company stock, that when the stock price fell from a high of about $90 a share to just pennies a share, employees lost their retirement savings. While Enron provided a generous match of company stock when employees invested in their 401(k) plans, it prevented them from selling their shares until age 50. Only 2,000 401(k) plans out of 340,000 have as high a concentration of company stock in their 401(k) plans as Enron did, according to the non-partisan Employee Benefits Research Institute. About 58% of assets in Enron’s 401(k) plan were in company stock. At a few companies, company stock represents more than 90% of plan assets. With people switching jobs more often now, many workers may get nothing from a pension plan. Employees can take their 401(k) plans with them when they leave a company. “But 401(k) plans were
never meant to be the sole source of retirement income” said Ronald Gebhardtsbauer, senior pension fellow at American Academy of Actuaries in Washington. They expose workers to the ups and downs of the stock market, a quality that people loved when stocks were headed higher but see as risky now. Regardless, Enron should serve as a reminder to everyone who has a 401(k) plan to review their portfolio regularly and to ensure that it is adequately diversified.

Steps that could have been taken in hindsight are always diversify and don’t ignore your portfolio. Diversification is the foundation of prudent investing, enabling investors to balance risk and return. Employees with nothing but Enron stock in their portfolios have been financial devastated. Employees with a small amount of Enron stock, conversely, will hardly be affected by the company’s bankruptcy. The higher a stock climbs, the farther it can fall. Mutual funds that have top-ranking returns one year often end up near the bottom the following year, because the fund manager has taken above-average risks to achieve such high returns. Likewise, company managers may take high risks that result in extraordinary stock performance one year – and a plunge in stock price the following year. Don’t ignore your portfolio. Enron employees might have heeded warning signs, such as the sale of stock by top executives. While many press reports have focused on a lockdown period during which employees were not allowed to trade their stock, share prices had already fallen from $90 to $30 by the time the lockdown period began.

Steps that the government and some regulatory forces have taken is limit company stock and shorten the length of time employees are required to hold company stock. Various proposals before Congress would affect the percentage of company stock
owned by employees. One bill would limit total company stock to 20% of assets, while another would not limit employer contributions, but would allow employees to contribute only 10% of assets into company stock. The most significant problem is that too many employees have too much invested in company stock. The dilemma with employer matches is that the investor with a third of his or her portfolio in a single stock has far too much riding on the success of one company – but the investor is better off that not having the stock at all. Many plans offer employer stock as an investment option, which is risky because an employee’s future is already tied to the company. Buying company stock just doubles the bet. Many companies match part of an employee’s contribution to a 401(k) plan in company stock. This is what Enron did and their employees bet that they would have great returns. In hindsight it would have been wise not to put all the eggs into one basket. A second issue is the length of time employees are required to hold stock. President Bush’s proposed reform would allow employees to sell stock after three years, while other proposed legislation would allow the sale of stock after 90 days. President Bush also proposed that if employees are not allowed to sell their 401(k) stock during a lockdown period, company executives should not be allowed to sell their non-401(k) stock during that period either. Elleen Koller watched the value of her 401(k) shrink from about $500,000 to $100,000 when she retired in May 2000 because she had two thirds of it in Enron shares, much of it from matching employer stock. “People say it’s gambling,” she said, “but when you love your company and you trust your company you leave your money in it.”