Question #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?

What is a 401(k)?

A 401(k) is a plan offered by most employers, which allows employees to put a certain percentage of their earnings into a retirement account. This account is comprised mostly of stocks, bonds, treasury bills, and other fixed income investments. Recently, 401(k)'s have become the norm in planning retirement.

The first 401(k) available was in 1980, and was offered by Ted Benna (Wilcox 24). Since 1980, the 401(k) has become almost a necessity for workers seeking long-term employment.

With the surging stock market of the 1990's, a 401(k) plan became even more attractive for investors. The enormous returns that people were achieving on their 401(k)s made anyone without one feel financially, like they were being left in the dust. Currently, over 40 million Americans have a 401(k) plan, and statistics show that this number will only keep growing.

The following are some basic facts about 401(k) retirement plans. 1) The maximum amount that you can put away in a 401(k) is $11,000 a year (Woolley 46). 2) A major benefit of a 401(k) is the matching principle, which is offered by most employers. For every dollar that employees put into their 401(k), employers will put anywhere from 50 to 100% of that amount in also, up to a certain percentage of the employees income, which is different for every plan. It usually takes a few years to become lawfully able to claim the amount that the employers have invested because employers want to give employees an incentive to stay with the company longer. The time frame for becoming eligible for the employers matching principle varies from company to company. 3) Another advantage of a 401(k) plan is that it gives the plan holder a tax break because the amount that is put into the 401(k) is not counted as income. In other words, a 401(k) is tax deductible.

An example of this deduction can easily be shown. Say you earn $100,000 a year, and would like to put 10% of that into your 401(k) every year. That means that $10,000 of your income goes directly into your 401(k) plan. That $10,000 is deducted from your earnings, so when you file for income taxes you only have to claim $90,000 in income. Of course, when you retire, you will cash out the 401(k) and have to pay taxes on that amount. With years of employer matching and returns on the market under your belt, a few thousand dollars invested may have grown ten or twenty fold or more.

What is the impact of Enron's bankruptcy on its employee 401(k) plan?

"Suddenly, the old admonition not to put all your eggs in one basket took on an unfortunate significance," (How To Improve 10). This quote was in direct response to the unfortunate impact that the Enron scandal had on the Enron employee's 401(k) plans. The problem with Enron's 401(k) plan was that too much of it was invested in Enron's company stock. Ted Benna, the first to offer a 401(k) to his employees, believes "Company stock should never exceed 15% of your 401(k) account. A more reasonable range is between 5 and 7%," (Wilcox 24). Remarkably, 62% of Enron's 401(k) assets were invested in the shares of the company (Diversify B2). The employees thought that this was acceptable though. Through listening to top executives and company analysts, employees thought they should invest in as much company stock as they could. "Upper management actively encouraged us to invest in Enron. They were predicting shares of $100 to $120 by February of this year," (Smolowe 122) claimed a former Enron employee. Obviously, those predictions were erroneous. So as the Enron stock went, so did their employee's retirement plans.

The stories about people who had lost everything soon followed Enron's collapse. An example of this disturbing effect is shown in the case of Tom and Karen Padgett, who had invested their entire savings and future for themselves in Enron's 401(k) and Enron's company stock. Their story is as follows:

> Last December (2001), after Tom's 401(k) topped $615,000, the Padgett's settled on next June to leave their jobs and sell their one-story brick house in the suburb of Mont Belvieu, east of Houston. But over the last two months Tom has watched in horror as his nest egg has withered to $11,000. Now he and Karen, 53, a part time nurse who suffers from debilitating arthritis, face years more work ahead. "We were going to move to the country and have a place with horses and cows and dogs, so when the five grandchildren came, they'd have animals to play with," said Karen. "We put away $600 a month so we could retire; now its not there," says Tom. "We're devastated. I told Karen last year that it looked like we were going to reach our goal. Now we're not going to realize it-and we were so close." (Smolowe 120-121)

Tom and Karen had spent their whole lives saving for retirement. They had passed on purchasing new cars and expensive vacations, just so they could retire with financial security. They were only months away from the future that they had always wanted when disaster struck. Now they will be working for years to come, knowing that they had been so close. They only wish they had made different decisions about how to save and what kind of investment strategy they should have used.

Another example is in the story of Janice Farmer of Orlando, Florida. Janice retired from Enron about a year ago with nearly $700,000 in Enron stock. After the Enron collapse, she cashed out her savings for $20,418 (Judice C1).

Enron employees like Mr. Padgett and Mrs. Farmer should have done their research to avoid the dreadful outcome that they are now faced with. Not only were employees getting their paychecks from the energy giant, they had most of their retirement savings tied up in the company also. They were depending on Enron for their financial security in the present and for the future. This strategy was doomed from the beginning. They had put everything into one basket, oblivious to the fact that sound investment strategy would tell them otherwise. Enron investors learned this lesson the hard way, losing nearly everything.

There were so many similar cases that involve large sums of money lost, that many lawsuits have sprung up. The impact and media coverage was so extreme that Congress is now getting involved and trying to pass bills that will modify and regulate 401(k) plans. Even President Bush has voiced ideas about how 401(k) law could be reformed. Now those employees who lost everything can only hope that somehow through the court system, they will be able to recover some of what was taken away from them. The question is what could employees have done differently to avoid the result that prevailed? How could they have set up more successful retirement plans?

Using hindsight, what should the employees have done in terms of putting together a retirement investment strategy?

In putting together an investment strategy for retirement, one should consider many things. One important aspect to take into consideration is the length of time until retirement. When do you want to retire? When do you think you will be able to retire? Also, it is important to think about how much money you will need in retirement. This is hard to predict because the future isn't known. Only estimations can be drawn up. Another important aspect that should definitely be taken into consideration is the risk of the investments that make up your retirement strategy. How much risk are you willing to take? What is the right amount of risk to take?

There is no right answer to the last set of questions. It all depends on your personal style. Stocks are risky in nature because they have the potential for large returns and equally as large of losses. There are ways of reducing the risk involved in investing though. You can eliminate part of this risk by simply adding more stocks to your portfolio, or your 401(k). By having small percentages of many stocks in the 401(k), you can eliminate most of the risk associated with stocks. Of course you can't eliminate all risk because the nature of securities is on a risk-reward scale. There will always be economic downturns, which usually lead to losses in the financial markets. Throughout the last 75 years though, the stock market has made more people rich and less people poor. Historically, large cap and small cap stocks have produced enormous returns for investors. Returns for these have been 13.3% and 17.6% respectively (Jordan 286). Also, many 401(k) plans include less risky parts such as corporate bonds, government bonds, and treasury bills. With the kind of returns discussed above, and the matching of invested funds by the employer, 401(k)s look like an extremely attractive investment. Returns then could range to well over 100% for the contribution by the employee, given that the matching principle and requirements to get the matching principle have been met. For employees, this is almost a no-brainer, and shows why 42 million Americans have a 401(k) presently (Woolley 46).

The only problem with the assumption that 401(k)s are great is the fact that not many of the plan holders are specialized in investing, which poses the problem that transpired at Enron. Enron was able to manipulate the 401(k) portfolio to its advantage through the purchase of its own stock, leaving little diversity within the portfolio.

"Diversify, diversify, diversify," (Judice C1) shout portfolio managers when questioned about what can be done to avoid investing nightmares like Enron. That's great advice for the 401(k) plan holders, but it's about a year too late. Senator Barbara Boxer claimed, "I believe that the only way we can protect working people from losing their life savings in the course of an individual company bankruptcy is to make sure that workers are not disproportionately invested in any one company" (Nalder 19). Of course, disproportionate investing is what brought down the life savings of former Enron employees. They had put all their chips on the table, when they thought they had a great hand, and got beat by a blackjack.

Diversification allows investors to be able to take the blow of something like Enron. When you have many stocks, and have small percentages of each of those stocks, you can virtually eliminate all risk associated with the investment. Say for example that the Enron 401(k) had only 5% of plan vested in company stock. The 401(k) would still have taken a 5% hit as a result of the recent bankruptcy, but would still be valued at 95% of what it previously had been, assuming the other investments in the 401(k) had retained their value through the ordeal.

But diversification wasn't what management to the employees. "Enron!" is what employees heard. For a while, the employees believed that management was right in their investment advice. The employees were riding high when the stock of Enron soared up the charts, and then crashed hard when the news about overstated earnings and accounting malpractice came about. Little did anyone know that the balance sheet was made up of virtual assets that hid actual debt that the company had incurred.

In 1999 and 2000, employee's 401(k)s had substantial gains with Enron's success. When the stock fell below a dollar, from above $90 a share, only months earlier, it depleted the 401(k) plans that employees of Enron had. 62% of their retirement plans were gone. This amounted to over 1 billion in losses for Enron employees (How To Improve 10).

Another unfortunate part of the fall of Enron was the change of the 401(k) manager. After the October 16th announcement of huge hidden losses, all employees could do is sit and watch their future dwindle away. Enron changed administrators for its 401(k) plan on October 17th, which locked down all trading in the employee's savings accounts for a month (Smolowe 120). With their accounts frozen and time working against them, 401(k) holders could do nothing but wait. "We couldn't divest," (Smolowe 122) claimed an ex-employee. With roughly 60% of their plan made up of company stock, plan holders were taking the risk of losing it all. They didn't know it at the time, but they were gambling with their retirement money. With the way they had set up their investment strategy, it was all or nothing. As they soon found out, the cards that had been dealt were not in their favor.

This last piece of information is not widely known by the public. I believe that much could have been saved if employees could have had the ability to maneuver their assets in their 401(k). But life isn't always fair in all respects. All we can do is learn from our mistakes. Hopefully, with all that has been learned about Enron and 401(k)s, history will not repeat itself.