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NO MORE ENRONS

Protecting 401(k) plans for a safe retirement

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Thousands of Enron employees recently lost most of their retirement savings when the company's stock plummeted and Enron filed for bankruptcy. Shady accounting practices and fraud may be ultimately responsible for Enron's failure, but the employees' losses were made much worse by the nature of their retirement plans and the extent to which their investments were concentrated in their employer's stock.

Compared to traditional defined benefit pension plans, 401(k) plans are so risky that saving for retirement becomes a gamble, rather than a source of security. Instead of a promised benefit backed by a federal guarantee, 401(k) plans allow employees to make investments that hold the potential for big losses.

Enron should teach us two lessons about retirement plan policy:

- Responsible management, administration, and investment of 401(k) plan assets requires setting prudent limits on the investment choices and asset allocation of 401(k) plans.
- 401(k) plans by themselves cannot guarantee adequate retirement benefits. More stable sources of retirement income, especially defined benefit plans, should be improved and their coverage broadened.

The retirement gamble: why the odds favor the house

Over the past 75 years stocks averaged an annual real rate of return of 7.3%. But that's only an average, and within that period rates of return have varied widely. For example, during the 20-year period ending in 1981 the real rate of return was less than 1% a year, while during the 20-year period ending in 1999 it was 12.5%. Such market swings mean that two people of similar means who invest similar amounts can end up with vastly different sums at retirement. After 40 years of contributing to a hypothetical account invested solely in stocks, a worker retiring in 1966 could have replaced 100% of her career-high earnings, whereas a similar worker

retiring in the late 1970s could have replaced only a little more than 40% (Burtless 2000).

This comparison assumes that workers do not modify their behavior in response to stock price changes. But in fact households tend to reduce their savings in response to wide fluctuations in stock prices – either up or down. When stock prices rise, households increase their consumption (and reduce their savings), and above-average increases in portfolio values also increase consumption above average. Ideally, this should also work in reverse – when the market falls people should start saving more to make up for the loss of assets, and when the market falls a lot people should start saving even more. However, market declines often go hand-in-hand with a weak economy, and households do not have enough money to save more. When the value of their total financial assets rose rapidly in the 1990s, households contributed 8.5% of their disposable income to financial assets – a historic low – but when the value of their assets fell dramatically, households contributed even less, 6.5%. The lesson here is that employees with highly volatile stock portfolios may actually save less. The surest way to limit volatility in individual accounts is through diversification of assets.

Financial markets fail consumers in another important way. As the Internet bubble of the late 1990s illustrated, stock price movements are often faddish (Shiller 1981). During those exuberant years, the market valued in the billions of dollars companies with no prospects for sales or profit growth. Drawn by the prospect of explosive stock price growth, households imprudently shifted money into these stocks. When the bubble burst in 2000, trillions of dollars in household assets vanished.

Stock market fads are not the only phenomenon that entice investors to put too many eggs in one basket. Another way the market fails consumers is by giving corporate executives both the incentive, through stock options, and the power to maintain inflated stock prices. Many observers blamed the sluggish stock market performance of the 1960s and 1970s on the fact that managers were paid regardless of a company's performance. Institutional investors subsequently decided they could transform the bear market by ensuring that managers had an interest in seeing their company's stock price rise. Hence, stock options proliferated as part of executive pay.

Managers pursue this vested interest in raising their company's stock price by spending corporate resources on stock repurchase plans, which allow managers to buy back the company's own shares, and dividend payouts. From the first quarter of 1994 and through the third quarter of 2001, U.S. corporations bought back more shares than they issued in every quarter but one. Also, dividends paid out of before-tax profits increased to a record 49% between 1990 and 2001. These stock repurchases and dividend payouts kept stock prices above levels justified by economic fundamentals. Researchers at the Federal Reserve pointed out that U.S. corporations would have had to dedicate all of their future profits to share repurchases and dividend payouts to keep stock prices from falling after issuing record numbers of stock options (Liang and Sharpe 1999). Thus, in many cases stock prices did not reflect the underlying value of a company, and rising share prices led individual investors to invest in companies that may not have been economically strong.

Enron's employees, of course, were misled more directly and to a worse effect than most other workers. Even as the corporation's top executives were dumping their own Enron stock, they were actively encouraging their subordinates to increase their holdings.

Different financial assets will perform differently over time. Nobody knows the winners or the losers before the fact, and most of the factors that determine the performance of a stock are beyond the control of individual investors. Diversification can help to minimize the downside risk. Consider, for example, a worker earning average wages who since 1980 contributed 10% of her wages to a 401(k) plan consisting entirely of Enron stock.

By 2001 she would have lost 94 cents for each dollar she contributed (in real terms). In contrast, had the worker invested the same amount in a diversified portfolio (say, 50% in bonds and 50% in an indexed stock fund) she would have received an additional $1.56 for each dollar contributed.

Policies to improve the odds

Require diversification. To reduce the risks associated with 401(k) plans, federal regulations should mandate the diversification of plan assets. This is not a new concept. Because of financial market risks, professional pension administrators are already prohibited from investing more than 10% of a plan's assets in the stock of a single employer. The same limit should also apply to 401(k) plan assets – measured across all of a worker's 401(k) investment options.

There are solid reasons for the government to set prudent limits on a worker's retirement investments. The alternative – to offer employees a flood of information and choices and to hope for an optimal outcome with respect to asset diversification – hasn't worked (Stabile 1998). In fact, research has shown that when employees are given a multitude of choices, they are likely to invest disproportionately in assets that showed good past performance, and they are likely to have a "familiarity bias" when company stocks are one of the investment options (Bernartzi 2001).

Without mandatory limits on single investments, employers have strong monetary incentives to keep employees invested in company stock. In particular, employers can save substantial amounts of taxes on dividends paid on employer stock held by employees in stock ownership plans (Schultz and Francis 2002). Also, employees are presumably a friendlier audience than other shareholders. Thus, employer stocks held by employees offer some protection from hostile shareholder proposals (Stabile 1998).

Some may argue that limiting employees' 401(k) investment options is paternalistic, and that employees should be free to make bad choices with their own money, even if that means losing retirement savings. But this argument overlooks the fact that taxpayers provide a $100 billion annual subsidy to pension, Keogh, and 401(k) plans (Joint Committee on Taxation 2002) to encourage retirement savings, and thus there is a public policy interest in ensuring not only that the funds are invested well, but also that a worker is not left destitute and a burden to society at retirement. (Of course, employees are free to use their own after-tax dollars for any high-risk investment they choose, including lottery tickets).

Require the availability of low-risk investment options. After the essential first step of mandatory diversification, it is also important to ensure that 401(k) participants have a full range of secure choices. Even if diversification is mandatory, employees could still be too heavily invested in assets with above-average risks, e.g., only equities, junk bonds, or industry-specific mutual funds. To compensate for this, plans need to offer lower-risk retirement savings alternatives, such as investment options with a minimum guaranteed rate of return that can be converted to an annuity when a worker retires. Not only do such investment options already exist, but they are also more in the spirit of saving for retirement than are high-risk, highly volatile equity investments.

Offering new products and mandating diversification may induce plan administrators to increase the fees that they charge plan participants. To ensure that employees receive the most efficient 401(k) plan option, employers should be required to absorb the administrative fees of such plans (Ghilarducci 2002).

Insure plan assets. Mandating diversification and the availability of low-risk investment options will help to reduce risks to plan assets, but employees' retirement savings may still be at risk for other reasons, such as changes in the corporate structure of the employer or fraud. The Pension Benefit Guarantee Corporation (PBGC) already screens defined benefit pension plans and insures employees against the loss of their retirement savings, within limits. Regulators should explore possibilities to expand this insurance to 401(k) plans (Ghilarducci 2002).

Strengthen other retirement arrangements. Aside from making 401(k) plans safe for retirement, other, less-volatile retirement savings vehicles, especially defined benefit plans, should be improved. Defined benefit plans are already subject to minimum funding rules that help ensure adequate assets to pay benefits even in companies that wind up in bankruptcy, and, as just mentioned, the PBGC insures employees' benefits within certain limits. Despite their security, the share of workers covered by defined benefit plans has been declining because the plans have drawbacks for the employer and the employee. But some disadvantages to employees in single-employer plans, such as lack of portability or slow accumulation of benefits, could be avoided by raising the attractiveness of multi-employer plans. These plans might be made more attractive for employers through tax incentives or by allowing non-collective bargaining employers to join collectively bargained plans (Ghilarducci 2001).

Conclusion

Workers like those at Enron who lose their retirement security are left with few choices, but among them are Medicaid, Food Stamps, housing assistance, and other government help. This kind of outcome should not be built into public policy, as it is now through the rules that govern many retirement plans. High risk needs to be reduced or eliminated in federally qualified employer retirement plans, and rules mandating diversification, low-risk options, and insurance availability will go far toward achieving that end.

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