The Dumbest Investment Move: Why Owning Your Company's Stock In Your 401(K) Can Be a Big Mistake

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There are plenty of stupid investments you can make in this world. Stock in Pets.com and Washington Mutual didn't work out so well. Nor did those Las Vegas condos. Some of the social media and Web 2.0 stocks flying high on Wall Street will probably follow suit. But the most foolish investment of all may be right in front of you. The investment? Stock in your own employer.

Late last year the Employee Benefits Research Institute, a think tank, published its most recent study of 401(k) retirement plans. The good news is that employees overall cut their exposure to their employers' stock; it accounted for only 8 percent of all 401(k) assets in 2010, continuing a downward trend that goes back to 1999, reported EBRI's Jack VanDerhei and colleagues.

The fine print isn't quite so good, it turns out. According to EBRI's data, only about 40 percent of 401(k) plans even offer the company's stock as an option. Employees in those plans are still investing from 16 to 19 percent of their plan portfolios, on average, in their employer's stock. At the same time, they have been shrinking their overall equity exposure dramatically. For those employees, company stock accounts, remarkably, for about a third of their entire equity exposure in the plan.

One dollar in your employer for each two dollars spread across all the other companies out there? It makes no sense.

But isn't it a good idea for employees to own a piece of the firm? Doesn't it incentivize them to work for the good of the company, to create value and put stockholders first? Phooey. This is what you hear, but it's little better than Orwellian propaganda. None of it stacks up.

Let's look at the flaws: First, you already have a big investment in your employer. You work there. If you are hoping to work there for some time, it may well be the biggest investment in your portfolio.

The value of an investment comes from its cash flow. Let's say you're hoping to earn a modest $45,000 a year for the next 10 years. An annuity producing that series of cash flows might cost you about $380,000. For 20 years: Nearly $600,000.

No, a job and an annuity aren't identical -- annuities don't demand you work for the money. But the analogy is useful. Your cash flow already gives you a huge stake in the company. Do you need to double down?

Legions of workers did just that and became two-time losers. Their employer collapsed. They lost their incomes and their savings at the same time. Think of Enron. Think of WorldCom.
Think of all those who worked at banks that collapsed in 2008. Bank of America and Citigroup avoided bankruptcy, but their stocks fell to pennies on the dollar.

In theory, at least, it would make more sense to bet against your employer -- or your entire industry -- than on it. That way, you're protected against an industry-wide meltdown. Any Lehman Brothers staffers who bought "put" options on the banking industry, or default swaps that paid out if their company imploded, would have had a better 2008.

The second problem with investing in your own employer's stock? It's based on the theory that you'll benefit from the company's improved performance and that you'll be incentivized to contribute. You'll be a stockholder as well as an employee, and you'll think like one. Employees buying company stock think they will have some influence over how it does.

Good luck with that.

The theory's fine if you work for yourself, or in a small partnership. But in a company of 500 or 1,000? Dream on. No matter how hard you work, you won't have any material effect on the share price. The only individuals who can do that are the senior executives.

Speaking of whom: Many people who buy company stock think they are following safely in the footsteps of top executives. But this, too, is an illusion. Even if the CEO holds $10 million in company stock, so what? His financial situation is totally different from yours. He may hold $50 million in other investments. If he gets canned, he may have a golden parachute and a network of golden handshakes to fall back on. So the "big bet" he's taking may not be what it seems.

And are CEOs really investing in the company? Most just get free stock and options -- which they then sell. Among top executives, stock "sales outweigh purchases by a substantial margin," says Lucian Bebchuk, a Harvard professor and a leading expert on executive pay; most of them, he adds, "keep getting equity incentives as part of their compensation and they unload them over time."

Vickers Stock Research, which follows executive trades, says that over time, the amount of stock sold by U.S. executives outweighs the amount bought by more than two to one. Do you think they know something?