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The Enron Pension Disaster

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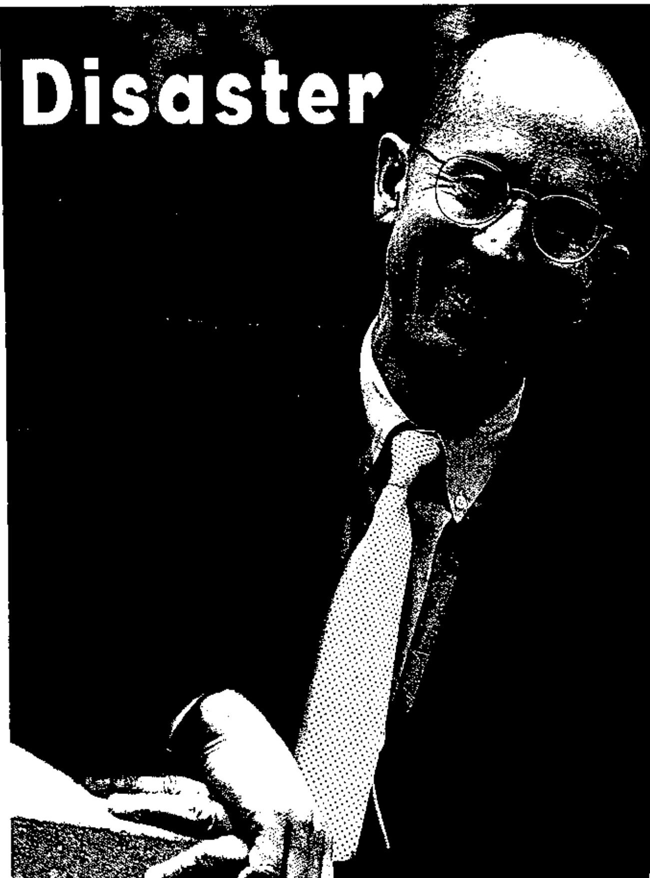
The Enron Pension Disaster



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DAVID MILLON, J.B. STOMBOCK PROFESSOR OF LAW AND ASSOCIATE DEAN FOR ACADEMIC AFFAIRS.

One of the most regrettable results of Enron's collapse is the destruction of retirement security for thousands of its lower-level employees. These people invested their pension dollars in Enron's own stock. This looked like a sound strategy as long as Enron was out-performing the market. But now, with the price having fallen from a high of nearly $90 to about 25 cents, the results are catastrophic. While thousands already have lost their jobs, even more have lost their hopes for a financially secure retirement. Disasters like this can be avoided in the future, but not unless Congress addresses the root of the problem.

Like many large corporations, Enron had a 401(k) retirement plan for its employees. This was a "defined-contribution" plan, which means it depended on contributions from the employees themselves. They could choose investments in a range of popular mutual funds. Or they could choose Enron stock. Enron also matched a percentage of each employee's contribution. Enron gave its employees no choice here—its matching contributions were entirely in the form of Enron's stock.

Under plans like Enron's, the employees bear the risk of their own investment decisions. If the investments do well, retirement benefits soar. But bad decisions can leave the retiree with nothing. These plans differ from traditional pension plans in which employers commit themselves to pay stipulated retirement benefits and assume the responsibility for ensuring adequate funds.

At Enron, the employees' individual investment decisions plus Enron's matching contributions resulted in nearly two-thirds of the retirement plan's assets consisting of Enron's stock. At a number of large companies, the percentage is even higher. Abbott Labs, Anheuser-Busch, Coca-Cola and Sherwin-Williams are only a few whose plans are invested over 80 percent in their own stock. At Procter & Gamble, the figure is nearly 95 percent.

Employees who choose, or are forced, to put the bulk of their retirement savings in a single stock face potentially disastrous risk. Modern portfolio theory teaches that diversification—investing in a range of securities instead of just one—can greatly reduce the risk of stock investment. If Enron's employees had followed this simple direction by putting their money in mutual funds instead of Enron itself, it wouldn't have mattered nearly as much that Enron's contribution was solely in the form of its own stock.

This isn't the first time a disaster like this has happened. Retirement plans at Nortel Networks, Lucent and Global Crossings, all heavily funded with company stock, also have plummeted along with the fortunes of the companies themselves.

Congress has before it proposed legislation that would require diversification in 401(k) plans by limiting the amount of company stock held by the plan to 10 or 20 percent. This effectively would prevent another Enron debacle, but the likely legislative result will not include this solution.

Opponents of mandatory diversification object to restrictions of employees' freedom to make their own investment choices. That argument should carry no weight in this context. Lower-wage employees, often lacking investment sophistication, are especially prone to misunderstand the risk of an undiversified retirement portfolio. Research shows they are *more* likely than higher-wage employees to over-invest in company stock, even though they are usually much more dependent on their 401(k) plans for retirement security.

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Can freedom of choice be maintained by requiring employers to educate their employees? The costs of trying to turn millions of Americans into sophisticated investors would surely be high. And could that kind of mandate really succeed? Even if it helps, education still might not make much difference. Pressure from the employer or misplaced feelings of loyalty—both evident at Enron—would probably continue to distort investment choices.

Critics of mandatory diversification also point to the productivity gains that can result from employees owning their company's stock. As investors, they will work harder. Company profits will increase. This is another bad argument. Research has yet to determine conclusively that employees who own stock work harder than those who do not.

Even if that claim were true, it rests on a fundamental misconception: 401(k) plans are supposed to provide post-retirement security. That's why Congress created them in the first place, endowing them with huge tax incentives. Efforts to turn these plans into a tool for increasing corporate profits, while ignoring the diversification problem, guarantees that disasters like Enron will happen again. Enhanced productivity is a fine objective, but it shouldn't come at the expense of retirement security for low- and middle-income Americans.