VIEWPOINT

RUSSELL INVESTMENTS RESEARCH

# Revisiting company stock in defined contribution plans

Defined contribution (DC) plan participants have been advised for decades on the benefits of diversification, but many still hold large portions of their account balance in employer securities. Company stock can be a retention incentive and can be used to align employee interests with those of the corporation. The corporate tax benefit of offering company stock is also potentially attractive: The company gets a tax deduction on the value paid out, and another deduction on dividends paid.[1] Despite these benefits, offering company stock can open the plan to lawsuits if the program is not carefully monitored and administered. As a plan sponsor, you may have wondered what actions are needed to protect the plan, and more importantly, the participants. This paper examines several issues regarding company stock ownership, recent litigation, and steps that some fiduciaries are taking.

## Introduction

DC plan participants frequently allocate too much of their total retirement portfolio to company stock. Company stock represents an average of 22.5% of defined contribution plan assets[2] among plans with more than 5,000 participants. While diversification can lead to more predictable outcomes than a concentrated single stock position, many investors have failed to diversify. This paper discusses why an outsized position in company stock might be considered inherently risky, and how a sponsor might help participants further diversify their portfolios.

Despite the investment risks, many companies continue to offer company stock in their DC plan lineups. Because of this, corporations can be legal targets for "stock-drop" lawsuits, which have been prevalent over the last decade. Plan sponsors want to avoid protracted litigation, settlements and legal fees, but they also want to prevent participants from over-allocating to company stock. We will discuss some steps fiduciaries have historically taken to protect participants and themselves, in the context of the recent U.S. Supreme Court case *Fifth Third Bancorp et al. v. Dudenhoeffer et al.*[3]

Specifically, we recommend the following if a sponsor decides to continue to offer a company stock fund, given the myriad of risks associated with doing so:

1. Consider plan design features to protect participants from over-allocating to it.
2. Consider re-enrollment into target date funds, when appropriate.
3. Thoroughly review plan documents related to company stock.
4. Review trading procedures around company stock, including monitoring cash drag if the stock fund is unitized.
5. Consider the benefits and costs of hiring an independent fiduciary.

**Exhibit 1: Comparing the volatility of single stock positions versus the index of securities**

| CATEGORY | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Average single stock position[4]** | 21.4 | 21.4 | 20.8 | 38.2 | 38.8 | 27.0 | 25.5 | 21.1 | 19.3 | 18.0 |
| **Russell Top 200® Index** | 7.4 | 5.3 | 9.8 | 19.4 | 21.6 | 19.1 | 15.3 | 10.7 | 8.4 | 7.9 |

Finally, we realize that plan sponsors may wish to exit company stock at some point. For those looking for an exit plan, we offer some guidance as to how they might approach such a process. It is good practice to consult the plan's ERISA attorney before taking any action in regard to company stock.

## Helping manage risks of investors in company stock

Company stock as an investment proposition can be very difficult to justify. We know that a single stock is not diversified and that a participant's human capital (defined as the present value of future earnings) is already tied to the prospects of the company for which he or she works.

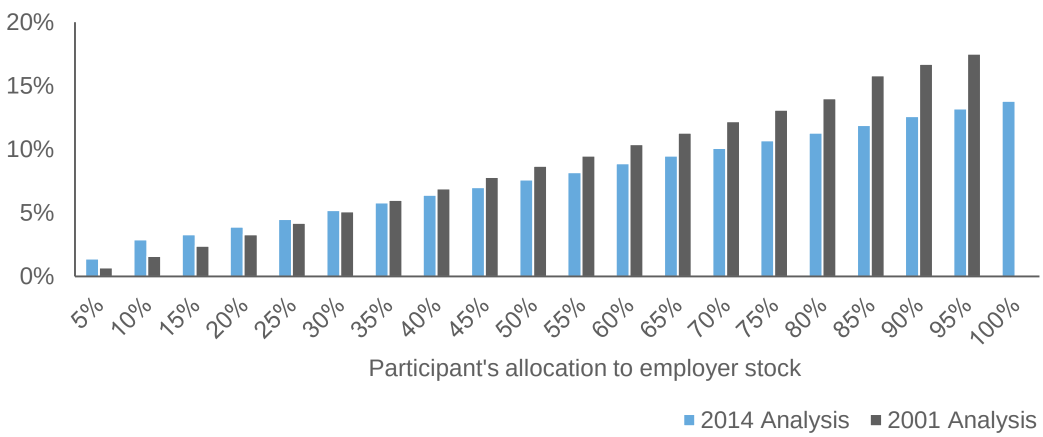
The results of our analysis of single stock positions shouldn't surprise anyone. The average volatility of all stocks in the Russell Top 200® Index was 18%, compared to the volatility of the index itself at 7.9%. In fact, our analysis shows that from 2005–2014, the average single stock volatility was twice that of the index, and could have been as much as four times greater.[5]

Given actual risk, return and correlation between individual stocks and the broad market, what does a certain percentage allocation to company stock tell us about participants' expectations for return? More than a decade ago, Russell Investments did an analysis to determine the implicit return expectation, relative to expectations for investments in other asset classes. Exhibit 2 follows a reverse volatility optimization to reveal the hypothetical expected outperformance of company stock, from both the 2001 study and updated with today's statistics. Based on the current analysis, an allocation of 20% to employer stock and 80% to the S&P 500 Index would mean that the stock would have to outperform the index by 3.9% per year to justify the additional risk.[6] This outperformance may be difficult to justify on a year in, year out basis.

Given this reality, how do you help guide participants away from over-allocating to an asset class with such uncertain outcomes? Here are several steps that various plan sponsors have taken. This list is not prescriptive, but rather is an example of things a plan sponsor could do in order to mitigate the potential risk of an undiversified allocation to company stock.

- **Increase participant education.** Educational materials have proven to be effective in moving small numbers of people to diversify. However, we know that inertia is high in DC plans, and sometimes a more proactive approach is necessary.
- **Place limits on company stock holdings.** An upper limit on the amount of company stock a participant can hold may curb excessive allocations. Yet explicit limits (for example, 20% to 30% of a participant's assets) may imply a recommendation to participants as to the appropriate amount of stock to hold. For plan sponsors who often don't want to imply asset allocation advice, this may not be palatable.

**Exhibit 2: Participants' revealed expectations for outperformance of employer stock over the U.S. equity index (p.a.)**




Source: Russell Investments

- **Close the company stock option to new participant money.** This may stop the flow of new assets, but it does nothing to help existing participants diversify. Furthermore, this may send a mixed message to participants about whether the company believes company stock is a suitable investment.
- **Re-enroll participants into the QDIA.**[7] The process of re-enrollment, or a participant's positive election to keep the current asset allocation, is an effective way to move many plan participants into diversified asset allocations.[8]
- **Monitor trading of company stock.** If company stock continues to be offered, trading and cash drag can have a big impact on participant returns. It is easy to think of the trading function of the recordkeeper and custodian as a relatively benign process, but a few nuances as to how the stock is traded can be observed. For instance, is company stock bought at the beginning of the day, or the end? Is the party doing the trading simply looking for execution, or are they also concerned about price? Finally, how is that party compensated?
- **Monitor cash drag if the fund is unitized.** Some company stock funds actually hold both stock and cash for transaction purposes. Plans with this structure have the additional responsibility of setting an appropriate level of cash and revisiting the allocation.

## Managing fiduciary risk: Implications of Fifth Third Bancorp et al. v. Dudenhoeffer et al

Generally, the biggest fear a DC plan sponsor has is of being sued by participants. Prior to 2014, there were several ways fiduciaries sought to protect themselves and still offer company stock as an investment option. In light of recent litigation, some of these options may not be as relevant going forward. We will discuss each in turn.

Before discussing the Fifth Third Case, some background is needed.[9] Fifth Third Bancorp offered company stock in its DC plan during the 2008 financial crisis, and the stock precipitously declined in value, due largely to the company's exposure to subprime mortgages. Plaintiffs argued that the fiduciaries knew or should have known that the stock was overvalued before the stock fell in value. Thus, the plaintiffs argued, the plan should have taken action to preserve the participants' assets. The Supreme Court ruled in favor of the defendants (it did, however, remand for further proceedings on the new theory), but the opinion written by the justices uncovered a few areas that plan sponsors should know about. Prior defenses of company stock had relied on the so-called "Moench Presumption" – the presumption that an offering of company stock was in itself prudent. The Fifth Third decision from the Supreme Court said specifically that this was not the case. The Court said that while company stock doesn't have to meet the diversification option like other options, it must be monitored for prudence like any other investment. The court stated that, absent any special circumstances, the market price of a stock is a prudent indicator of the firm's value.

Prior to the Fifth Third decision, investment committees were taking actions to protect themselves. Most common was "hard-wiring" the company stock into the plan by requiring, via plan documents, that company stock be offered. After the ruling, the court made it clear that there still has to be a determination of prudence. Committees also took steps to remove insiders from the investment committee. While this may be good practice for removing the potential for insider trading actions, the decision specifically stated that inside information should not be used in making a determination of whether to offer company stock as an option.

Since this ruling, we have seen plan fiduciaries take other actions. First, they are trying to amend potentially ambiguous language in plan documents that relate to company stock. Second, they are establishing a diligent process for determining whether company stock is a prudent investment. This may mean bringing in outside experts to evaluate the option. It may also mean establishing a process for removing the stock as an option if that option is deemed imprudent. Lastly, investment committees are responsible for determining what would constitute a "special circumstance" where the market price could no longer be relied upon as a measure of value.

## What if you want to liquidate company stock?

Given the aforementioned risks, some plan fiduciaries have decided to terminate their company stock plan altogether. If you had to get rid of company stock as an investment option, how would you do it? Plan sponsors should think about a plan to wind down the company stock program, in case liquidation does become necessary at some point. An effective liquidation would minimize the market impact of selling company stock and ensure that everyone is treated fairly. This is a difficult task, but an independent third party, rather than the plan sponsor, may be able to decide and deliver on a conflict-free solution to these issues.

But how does one actually wind down a company stock program? Participants are given notice to make new investment elections, well in advance of any selling. The party charged with the task of liquidating the company stock will begin a systematic process, informed by market conditions, whereby the market impact of selling the company stock is minimized, and of ensuring that accurate records are kept. Finally, that party will oversee the transition of the company stock program into a designated investment option, which in many cases will be an age-appropriate target date fund.

However, simply hiring someone to liquidate the company stock position does not relieve the plan sponsor of its fiduciary liability for prudently selecting plan providers and advisors. A third-party provider most commonly acts as a discretionary ERISA 3(38) Investment Management Fiduciary over the stock position, though they can take many different roles. Plan sponsors would need to evaluate the provider of these services, just as they would monitor any other investment manager.

The plan sponsor must make sure that all decisions on liquidating the company stock and the methods chosen for such a liquidation are in the best interests of plan participants. That's what ERISA requires plan sponsors to do.

## Conclusion

There are benefits to offering company stock as an investment option, but there are also risks, both to the plan sponsor and to the participants. For participants, the biggest risk is that they will invest too much of their balance in the stock fund, and that the stock will underperform. We have shown that participants' implied expectations for extra return from company stock may not be realistic, given the concentration that many investors have. Thus, if you decide to continue to offer company stock as a sponsor, we think it's prudent that you help participants understand and manage these risks.

For the fiduciary of the plan, the biggest risk is that the plan may be sued for not acting prudently. Even when a plan sponsor acts in a prudent manner, participants can still bring a lawsuit, which can be costly in terms of lost time, legal fees, and reputational risk, even if it is later dismissed. The key is to be able to demonstrate a prudent and thorough process for evaluating the appropriateness of, and monitoring the implementation of, the company stock program.

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[1] 401(k) Matching Contributions in Company Stock: Costs and Benefits for Firms and Workers. Jeffrey R. Brown, Nellie Lang, and Scott Weisbenner. Referenced at: http://www.federalreserve.gov/pubs/feds/2004/200423/200423pap.pdf

[2] PSCA's 57th Annual Survey, 2014

[3] Fifth Third Bancorp et al. v. Dudenhoeffer et al. Referenced at http://www.supremecourt.gov/opinions/13pdf/12-751_d18e.pdf

[4] Source: Russell Investments analysis. The average 1-year standard deviation of single stock positions of the Russell Top 200® Index for the period 2005–2014 was 25.2%, and the volatility of the Russell Top 200® Index was 12.5%.

[5] See endnote 4.

[6] "DC Participants' Implicit Return Expectations for Employer Stock," Russell Investments Research paper, December 20, 2001.

[7] Qualified Default Investment Alternative

[8] In Bidwell v. University Medical Center, Inc., 685 F. 3d 613 the plan was sued for re-enrolling participants into the QDIA from a stable value fund. In this case, the plan met a series of conditions set forth in the QDIA regulations, and therefore was provided safe harbor under those same regulations

[9] For more information on the case, please see "Supreme Court decision in Fifth Third Bancorp et al. v. Dudenhoeffer" by Michael Barry at http://planadvisoryservices.com/public/features/fifththird.html

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