

## Dangers of Not Diversifying Hit Investors

Mutual-fund firms and financial planners have droned on about the topic for years. But suddenly, it's at the epicenter of lawsuits, congressional hearings and presidential reform proposals.

Diversification -- that most basic of investing principles -- has returned with a vengeance. During the late 1990s, many people scoffed at being diversified, because the idea of investing in a mix of stocks, bonds and other financial assets meant missing out on some of the soaring gains of tech stocks.

But with the collapse of the tech bubble and now the fall of Enron Corp. wiping out the 401(k) holdings of many current and retired Enron employees, the dangers of overloading a portfolio with one stock -- or even with a group of similar stocks -- has hit home for many investors.

George Maddox of Van, Texas, is one of them. After retiring as an Enron natural-gas plant manager in 1992, when his eyesight failed, Mr. Maddox, now 68 years old, kept his retirement-plan money invested entirely in Enron stock. "I lost \$1,244,000," says Mr. Maddox, who has other retirement income but postponed plans to build a new house because of the loss.

The pitfalls of holding too much of one company's stock aren't limited to Enron. Since the beginning of 2000, nearly one of every five U.S. stocks has fallen by two-thirds or more, while only 1% of diversified stock mutual funds have swooned as much, according to research firm Morningstar Inc.

While not immune from losses, mutual funds tend to weather storms better, because they spread their bets over dozens or hundreds of companies. "Most people think their company is safer than a stock mutual fund, when the data show that the opposite is true," says John Rekenhaller, president of Morningstar's online-advice unit.

How much of an employer's stock is too much? Situations vary, of course, but experts such as Mr. Rekenhaller think investors take on undue additional risk if more than 10% of their overall financial portfolios (excluding such assets as homes and cars) is held in their company's stock. Mr. Rekenhaller half-jokingly says that company stock should carry a warning label for investors, much like those on tobacco products.

Indeed, if their employer fails, investors who hold most of their assets in company stock not only can lose their job and their life savings, but they even run the risk of declining home values if they worked for a large employer. Still, many employees feel a sense of loyalty, in part because they are familiar and comfortable with company stock. Many feel they are heeding the advice of famed fund manager Peter Lynch, who urged investors to invest in what they know best.

Whatever their motivation, employees in 401(k) plans have about 30% of their assets in their company's stock -- making it the single most common stock category, according to a study by Hewitt Associates, a Lincolnshire, Ill., consulting firm. And retirement-plan investments in company stock have risen since the mid-1990s.

Employers don't always make diversification easy. Many companies match 401(k) contributions with company stock, and most of those put restrictions on when employees can sell the shares; a third of them, like Enron, bar employees from selling company-contributed stock until age 50 or later. Such restrictions can make it difficult for workers to spread their investments broadly enough.

Following Enron's demise -- with the loss of \$1 billion in the value of the company stock that workers held in the 401(k) plan -- numerous legislators and regulators have proposed steps to make it easier to sell an employer's stock or to limit how much workers hold of such stock in their accounts. But before any such changes, there are still actions that investors can take to help improve their portfolio diversification.

Start by looking inside your 401(k) plan itself, says Ross Levin, a financial adviser in Edina, Minn. Most company plans offer access to a range of diversified stock and bond funds, money-market funds and other options, in addition to the employer's stock. (A number of 401(k) plans offer tools for employees to analyze how diversified their retirement portfolio is and receive recommendations for changes; some public Web sites such as MSN Money's [moneycentral.msn.com](http://moneycentral.msn.com) offer free access to similar tools.)

So while some companies will match employees' 401(k) contributions exclusively in company stock, investors can almost always diversify a large portion of their 401(k) -- namely, the part they contribute themselves. Half or more of the assets in a typical 401(k) portfolio are contributed by employees themselves, so diversifying this portion of their portfolio can make a significant difference in reducing overall investing risk.

But in picking an investing alternative to buying your employer's stock, some choices are more useful than others. For example, investors should take into account the type of company they work for when diversifying. Workers at small technology companies -- the type of stock often held by growth funds -- might find better diversification with a fund focusing on large undervalued companies. Conversely, an auto-company worker might want to put more money in funds that specialize in smaller companies that are less tied to economic cycles.

Investors can take the next step to greater diversification by piecing together several funds -- either from their 401(k) plan offerings or from their Individual Retirement Accounts, variable annuity contracts or other savings vehicles -- to get a mix of investments that are unlikely to all sink at one time. One possibility is to split investments among a small-stock fund, a large-stock fund, a bond fund and perhaps a small allotment in an international stock fund.

Another approach would be to find a "one-size-fits-all" fund with a broad investment mandate to hold stocks, bonds and sometimes cash all under one roof. Portfolio managers of these funds, which include so-called balanced and life-cycle portfolios, adjust their mix among the asset classes to best take advantage of changing conditions.

Such funds are getting more popular in company retirement plans: About 35% of 401(k) plans offer life-cycle funds and 72% offer balanced funds, up from 30% and 70%, respectively, in 1999.

Of course, investors who diversify out of their company's stock also run risk of missing out on some big financial success stories. A number of firms whose employees have invested a large percentage of their 401(k) assets in company stock, including General Electric Co. and Home Depot Inc., have enjoyed outsize gains in the last 10 years.

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**AWAKENING THE FUNDS:** Several fund companies said they wanted more information on a proposal that institutional investors should unite to demand better corporate practices in the wake of Enron.

As expected, Vanguard Group founder John Bogle yesterday proposed that buy-and-hold oriented investment firms such as Vanguard, TIAA-CREF and Barclays Global Investors, a unit of Barclays Bank PLC, should form a new group to lobby for better rules on a variety of corporate

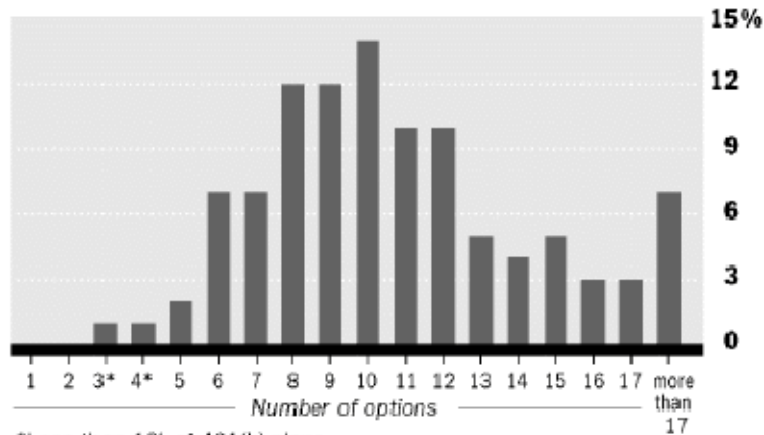
issues. Asked to respond to the idea, the three fund firms said they would review it if Mr. Bogle put something more concrete in writing about how such a body would work and what its goals would be.

- Aaron Lucchetti

## Despite Many Options, Not Many Diversify

### Most 401(k) plans offer multiple investment options...

Percentage of 401(k) plans offering each number of investment options



\*Less than 1% of 401(k) plans

### But not all investors take advantage of all their options

Most investors tend to concentrate their funds in fewer investments

INVESTMENT OPTION	PERCENTAGE OF PLAN ASSETS INVESTED IN EACH INVESTMENT	401(k) PLANS OFFERING EACH INVESTMENT OPTION
Employer stock	30%	55%
Large-capitalization stock	19%	85%
Stable value <sup>1</sup>	16%	69%
Stock index	11%	70%
Balanced	4%	72%
Small-capitalization stock	3%	70%
Money market	2%	53%
Intermediate/long-term bond	2%	45%
Global stock <sup>2</sup>	2%	42%
Emerging markets	Less than 1%	15%

<sup>1</sup>Includes guaranteed-income contracts, or GICs, synthetics

<sup>2</sup>Global stock includes non-U.S. and U.S. stocks

Source: Hewitt Associates 2001 survey of 428 employers