

# Planners Instill New Reality for Retirement Planning for Corporate Executives

by Nancy Opiela

“In the 1990s, the sky was the limit. Now clients are more concerned with downside protection. They’ve seen their net worth shrink and they want to know what they can do to protect themselves,” says William Herr, CFP, CFA, of Herr Capital Management LLC in Chicago, Illinois. The story is much the same when talking to other financial planners who work with highly compensated corporate executives.

With 401(k) accounts worth less, stock options under water and accounting scandals rocking corporate America, planners are noticing some changes with their corporate executive clients. While the root of the generally conservative mood among executives could be traced to Enron’s bankruptcy, clients are, of course, most profoundly affected by the local economic climate and the financial health of the companies they work for. For example, the clients of William B. Burns, Jr., CFP, of Burns Matteson Capital Management in Corning, New York, are either current or retired employees of Corning Incorporated. Burns started his practice in December 2000 after Corning stock had fallen 30 percent from its peak that September. Within another month, the stock was down well over 50 percent. Today, the stock that once soared to \$113 sits at \$2.

“Corning has laid off thousands this year in a corporate restructuring,” says Burns, “from lower level managers who have been with the company just a few years to senior executives with 20 years of service. For these executives who were earning a low six-figure income, it’s very tough. We have several couples who both had upper level positions at Corning and one of them was let go. If the glass is half full, you say at least one of them has a job. But realistically, if the other spouse has been told there is no work for them at Corning Inc., that essentially means there is no work for them in the city of Corning. So, we have couples where two people are looking for jobs outside of the area.”

Whether sparked by national events or local economic woes, planners have noticed a move from what Federal Reserve Chairman Alan Greenspan called an “irrational exuberance” in the late 1990s to a more realistic market assessment. Says Tim Kochis, CFP, of Kochis Fitz Tracy & Gorman in San Francisco, California, “There’s a general sense that economic opportunities are not going to be as easy to come by as they once were. Nobody is despairing—they’re just accepting a new reality and acknowledging that things were exceptionally, perhaps undeservedly, good in the late 1990s. Corporate executives were rewarded for hard work, but the value of those rewards was exaggerated by the performance of the equity market.”

Retirement planning, too, has undergone some changes, with many clients (even highly compensated executives) working harder and for less than they did several years ago. And they’re less optimistic about the future.

## The Concentrated Position

All the planners we spoke with agree that the Enron story, splashed over front pages, has resulted in clients paying attention to what has long been problem number one for high level corporate executives—concentrated positions in company stock.

Says Larry Martin, CFP, of International Wealth Management in Grapevine, Texas, “Prospects arrive at the door loaded up with company stock. Their 401(k) plans have a dozen choices, and even though their contributions are matched in company stock, employees choose the company stock as an investment option for their own dollars. In addition to the 401(k), they might have a deferred compensation plan and they choose the company stock there, too. They also may have stock options and a pension plan, which compound the concentration in one stock. All these sources can combine to make up a retirement plan that is 90 percent concentrated in their company stock.”

Martin notes that concentration in company stock was not an issue many clients felt inclined to deal with in the

late 1990s. “My clients are loyal, hard working, and believe in their company. They don’t want to dump stock or do anything that would make it look as if they don’t have faith in the company,” he says.

For that reason, Martin stresses the value he brings to the planning arena as an independent person without an emotional attachment. “Clients benefit from me being separate from their company and providing analysis that takes the emotion out of the equation,” he notes.

J. F. Helfrich, CFP, of SYM Financial Corporation in Warsaw, Indiana, agrees with Martin that clients become dangerously myopic when it comes to evaluating their own company. “They don’t see the problems that an outsider would, so it’s my job to try to be a voice of reason with a second opinion,” he says. “As we go through planning scenarios, it’s a good idea to show what a pessimistic outlook for their company might mean over the long term. A major economic event that causes their company stock to tank could have a pretty serious impact on what they think their lifestyle is going to be in the years ahead and in retirement.”

Continues Helfrich, “I also stress to clients that, in addition to stock, their livelihood is *a/so* tied to their company, and they may have additional exposure if they live in an area that the company dominates. The company’s fortunes can influence the real estate market and affect the value of their home.”

In general, planners see their role as keeping the client educated about the risk of the company. Notes Herr, “When you are walking the halls all day with people who are all invested in the same stock and you are excited about the company, it’s easy to think the stock’s going to the moon. It’s easy to forget that the idea is to buy low and sell high.”

In fact, the current market has Herr revisiting what he says used to be taboo—advising clients to diversify away from company stock held in their 401(k). “Moving out of company stock means that, come time for withdrawal, clients lose the advantage of company stock receiving long-term capital gains treatment as opposed to other investments being taxed as ordinary income. I’ll review the pros and cons with clients, but in some cases we have chosen to sell company stock inside the 401(k) because the client has 70 percent exposure to their own company and that doesn’t make sense. We have to weigh current risks versus future tax advantages,” he says.

Of course, there is a Catch 22 when it comes to the concentrated portfolio. As Viktor Szucs, CFP, of Quest Capital Management in Dallas, Texas, describes it, “Although clients are more receptive to our message, there is often a watermark in their head, a price the stock had attained at some point and they can’t bring themselves to sell at a deflated price.”

In Szucs’ experience, a number of factors are involved in the decision-making process when it comes to a concentrated position, and most are “nonfinancial, emotionally based factors.” Says Szucs, “You can least afford emotions to be part of decision making when the decision is difficult and complex, as it is with a concentrated portfolio. In so many cases, clients have watched the stock move up from zero. They have their own sweat equity in the company and believe they have contributed to the growth of the position. They are reluctant to make a change because they are projecting past positive performance into the future, with no regard for the current economy or risk. They think they are making a decision based on hard evidence, but it’s all emotionally driven. In that case, my job is to identify and deal with the emotional patterns they are experiencing. Often, logic won’t get you anywhere.”

The concentrated position, says Szucs, must be viewed within the framework of the client’s overall financial plan. “We need to ask the right questions: Are we financially independent today? How much is enough for today and tomorrow? What’s the outlook for the concentrated position? Are there opportunity costs? Are there better opportunities? What risk is the client taking with the concentrated position?”

Kochis cautions, however, that planners must avoid a “knee-jerk response” to a concentrated portfolio. “It may be that the client is in a position to accept the risk of the concentrated portfolio,” notes Kochis. “If they have enough elsewhere to meet their goals, it may not be necessary to diversify away from the company stock. We can’t assume that the only intelligent thing to do is to diversify away from the concentrated position.”

Assuming it's in the client's best interests to diversify the concentrated position, where do you start? While many clients will be interested in strategies to defer or minimize taxes, Kochis cautions planners not to overlook the obvious. "If you just sell the stock—and let's use California as an example—even if you have no basis, the worst-case scenario would be that you'd get 74 cents on the dollar," he notes.

Adds Martin, "As we think about a program to pull away, there are some things we can do immediately. For example, the client can stop choosing company stock in the 401(k)."

As for managing around the concentrated position, Herr notes that executives who are required to hold a certain amount of company stock could begin by buying a put on the company stocks they own. "Buying the right to sell a stock at a specified price is essentially buying an insurance policy," he says.

Herr also uses equity collars. "Because puts are kind of expensive right now with the market volatility, you sell a call to finance the put. The downside to a collar is that you limit your upside. For example, if the stock is trading at \$50 a share and you buy a \$30 put and sell a \$70 call, your upside is from \$50 to \$70. After that, you've sold the right to any more appreciation," he explains.

Adds Burns, "Whenever an equity collar is used, we must be mindful of potential tax problems. If an equity collar eliminates virtually all of the downside risk and upside potential of holding the stock position, the IRS constructive sales rules may be triggered. If a constructive sale is determined to have occurred, any built-in gain on the stock is recognized for tax purposes, as if the stock were actually sold. In addition, equity collars trigger the tax straddle rules, which may limit the investor's ability to take losses, and limit the investor's income tax deduction for any investment interest paid. The tax straddle rules also may prevent holding period accrual for the stock in situations where the stock has not already been held for a year" (as in the case of newly exercised employee stock option shares).

A prepaid variable forward is another derivative instrument that could be useful to investors who may be prohibited from selling their stock due to SEC (Securities and Exchange Commission) restricted stock rules. Explains Burns, "A prepaid variable forward contract is similar to the equity collar strategy. The prepaid variable forward allows investors to protect their concentrated equity position while still participating in potential future price appreciation of the security. The primary difference between the prepaid variable forward and the equity collar is that the financial institution entering into the prepaid variable forward contract with the investor typically will lend the investor an amount up to the downside 'floor' of the prepaid variable forward contract.

"If the floor of the contract is 90 percent of the current market value of the stock," Burns continues, "an investor with \$2 million of Corning stock could immediately receive \$1.8 million in cash at the time the prepaid variable forward contract was written. This cash could then be used to invest in a diversified portfolio to further hedge the concentrated equity position, or for other cash needs of the investor."

Kochis notes that a taxed-managed index account also can be employed to manage around a concentrated position. "We'd establish the account and aggressively harvest tax losses to offset gains in the concentrated position," he explains. "This is not a permanent solution, but a technique we can use along the way."

Kochis adds that the temporary use of margin can be used to deal with a concentrated position. "You reduce the risk of gross assets by acquiring more assets and building a broadly diversified portfolio with them," he says.

While planners can offer clients many reasonable alternatives, they often are not ready to listen to reason. Explains Szucs, "If a client is unwilling to move out of a concentrated position, we ask them to document their position."

## Deferred Compensation Plans

The down market is causing the planners we spoke with to rethink their advice to clients on deferred

compensation plans.

“Enron has made everyone more concerned with diversification and separating themselves from the company a little bit,” explains John A. Kvale, CFP, of J.K. Financial Inc. in Dallas, Texas. “Today, clients tend to be much more skeptical of these deferred compensation plans. I’m hearing worries I didn’t hear in the late 1990s when the markets were so much more stable. I’d say 50 percent of the concerns coming from clients have to do with market volatility and the other 50 percent of the concerns center on the company itself.”

The ideal person to elect a deferred compensation, Kvale suggests, is someone whose 401(k) is not matched in company stock or an employee whose stock options have been exercised. “In those cases, we’ll look to defer the gravy, the amount of funds they may not need to live or meet future goals. However, the current investment environment has made clients more conservative in electing these plans. In fact, I’m more conservative too. The market has been so volatile that, in some cases, taxes are taking a back seat,” he explains.

Finally, Kvale insists that clients considering deferred compensation evaluate the fine print, specifically how they could lose their deferred compensation. “If you are fired for some reason, often a reason that is very broad, you can lose some of your deferred comp benefits. Sometimes, payment will just accelerate forward and start paying them out,” he notes.

Adds Burns, “Deferred compensation is an unsecured promise from the company. People are more concerned about leaving any money in the company that is not secured in a 401(k) plan or a pension. Tax deferral used to be beneficial but with bonuses down, stock options under water, pay freezes, and little or no capital gains from mutual funds, tax liability is already lower than it was a few years ago. Therefore, tax reduction strategies, while still important, are not the primary focus anymore.”

Says Helfrich, “I tell clients that deferred compensation makes them a creditor of the company. They are loaning their money back to the company. When there are limited investment options, or when you can elect only company stock, those are dangers I have to point out.”

Adds Kochis, “Marginal tax rates are going down, so we’re still taking advantage of deferred compensation plans. If, however, the only choice is company stock, we’d discourage it because the clients have a lot of company stock already. If the deferred compensation program has a variety of investment options, it’s still something we’ll take advantage of.”

John W. Wimbiscus, CFP, of Trinity Financial Advisors LLC in Chicago, Illinois, agrees that investment options make the deferred compensation plan. “When the company has limited options, we don’t get as excited about deferred compensation,” he says. “That said, I have one client with just one option for deferred compensation—a fixed-income option at 4.25 percent. She’s five to seven years from retirement and her risk tolerance is such that she wants something in a fixed-income investment, so we decided that we would use that option as her fixed-income investment.”

Says Wimbiscus, “Historically, people might not have been bothered keeping deferred compensation at the company and taking a ten-year payout. Now that we’ve been through this economic downturn and they’ve seen Sears and K-Mart go into bankruptcy, the attitude is, let’s take a lump-sum distribution the day I leave.

Wimbiscus notes that clients also are electing the lump-sum distribution for nonqualified pensions. “There is no guarantee, no right to that nonguaranteed pension if the company is taken over,” he explains. “The acquiring company could pull the plug. The day they take over, the annuity stops. Sometimes clients have faith in the company and think it’s fine to wait for ten years. However, when it’s all or nothing, there’s too great a risk. If the company has a problem, they could lose everything. I wouldn’t want to be in court explaining why I recommended a ten-year payout.”

## Stock Options

With stock options either gone or worth much less, planners are working with clients to re-assess if their resources are adequate to accomplish their goals. And, in the grand planning picture, clients are looking at their stock options a little differently.

Says Wimbiscus: "Clients are not banking on huge funds from the sale of their options to bail them out. In that way, they're tightening up a bit and taking responsibility for their other investments. They are no longer looking to their options to make up any shortfalls. Now they are asking, 'If my options stay under water, what does retirement look like?'"

The main thing, says Martin, in constructing a new world view for options, is to "put together a plan to manage the stock options." We're looking to protect value if the client is older. If the client is younger, we'll try to take advantage of some growth," he notes.

Adds Wimbiscus, "It's necessary for clients to understand that their company is no different from companies like Enron, where they thought the stock was going to the moon. What we need, then, is a systematic program for exercising options."

Finally, Burns points out that options under water raise some insurance concerns. He notes, "I have a client who came to us six months ago with a ton of stock options in restricted stock. In 2000, they were worth \$25 million, but they all had a two-year vesting period. In April of this year, with the vesting period up, that same pile of money was worth about \$700,000. His wife stays at home with two or three children, and in previous years he'd look at the balance sheet and think that if something happened to him, his family would have the \$25 million to replace his income. Even though \$700,00 is a decent amount of money, he's earning \$300,000 a year, so that's just a few years of his income.

"The first thing we did was to beef up his insurance program, primarily term insurance," continues Burns. "The way we've presented this to him is that we are really renting, hopefully short term, the net worth that has been ruined by the decline in the stock. If we take out a 15-year policy for \$15 million, the goal is that within 15 years, the value of the stock recovers, options are above water, and at that point the insurance isn't necessary. We're renting the net worth the family used to have."

## **Maintain the Connection**

There's no question that anxiety is prevalent, springing from the fact, as Wimbiscus notes, that clients can no longer "view the market as a 20 percent CD."

Clients are experiencing stress over their own employment security. Says Herr, "Clients in their forties and fifties have some longevity in the business and are making a great income. If they get fired, they'll get another job, but they understand that their income could be cut in half. That's the trouble with highly compensated executives. There are not a lot of \$500,000 to \$700,000 jobs out there."

Planners stress that more client contact and objective analysis are critical in times of such market turbulence and personal unrest. "Our clients are leaders, but they are still looking for our leadership," says Helfrich. "Often, I'm the prophet in the wilderness; I have a different voice than they hear on a daily basis. In their offices, everyone is a cheerleader and they all believe in what they are doing. I'll research the companies my clients work for and try to provide the investment world's view of the company. I'll ask, 'If I marked out the name of your company on the annual report and you then evaluated the company, would you invest?'"

In conclusion, Szucs' observations underscore that whatever the expertise of the executive client, there will always be a role for the objective and educated voice of the financial planner. "When I talk to clients about their market outlook, all I hear is, 'This time it's different.' Of course, the last time I heard that was in 1999 when people were touting the new economy and all its promises," he says. "So, the more things change, the more things stay the same. Throughout all these market cycles, however, the one constant is psychological factors. No matter who you are, you need help guarding against emotional decision making."

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