When It Comes to Saving for Retirement, Here's Something Both Parties Can Agree On

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MarketWatch Blog by Geoffrey T. Sanzenbacher

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Are ESOPs actually a good idea?

Warren Buffet is known to have said about diversification: "[it] makes very little sense for anyone that knows what they're doing." As someone with his retirement savings mainly in diversified index funds, that quote hurts. Then again, when it comes to my retirement savings, I don't really have the time or desire to become someone who "knows what they're doing." So, I diversify with the goal of securing the market return and often recommend that others like me do the same. Which is why when the Secure 2.0 Act was signed into law in December 2022, I was just a bit nervous about the provisions encouraging the adoption of Employee Stock Ownership Plans (ESOPs).

Before getting in to why I was nervous, a quick primer is in order. After all, many people reading this post may be more familiar with Aesop's Fables than ESOPs (rim shot please). Probably the quickest way to explain ESOPs is to contrast them to the 401(k), a retirement plan that most workers know better.

Contributions: In a 401(k), employees contribute a fraction of their salaries – pre-tax for Traditional and post-tax for Roth – into an account. Employers will often match a portion of their employees' contributions. In ESOPs, employees typically make *no* contributions. Instead, employers distribute shares of company stock to employees' accounts based on things like their salary and tenure.

Investments: In a 401(k), employees choose how to invest their contributions from a menu often including both actively and passively managed funds. ESOP accounts generally hold only employee stock, although employees can diversify up to 25 percent of their accounts' shares at age 55, increasing to 50 percent by age 60.

Account Value: In a 401(k), the value of one's account is usually obvious, because the assets involved are publicly traded. The value of an ESOP account is the value of the employer's shares. This value may be clear if the company is publicly traded, but for privately held companies it is made available only annually.

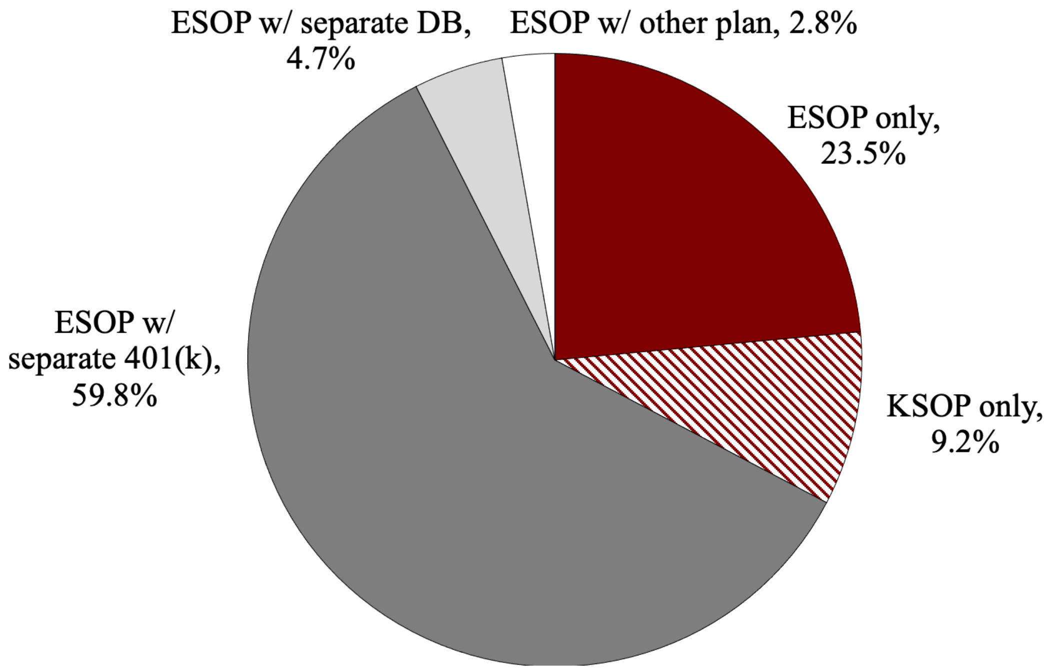
Distributions: In a 401(k), employees older than 59½ can withdraw their contributions and returns as they wish (subject to the required minimum distribution rules). Withdrawals are subject to the ordinary income tax if the contributions were pre-tax. In an ESOP, distributions are more plan-specific, and often out of the control of the participant.

From the above, you can see why ESOPs are attractive and often receive bipartisan support. First, ESOPs don't require a contribution from employees and are therefore often seen as ideal for middle-income workers (although it is always possible that employers compensate for offering an ESOP by lowering employee wages). The fact that about a third of ESOPs are in construction and manufacturing – industries thought of as squarely middle-income – reinforces this appeal. Second, ESOPs give employees an ownership stake in their company, increasing their motivation as well as their empowerment.

However, the contrast to 401(k)s also makes clear why the push for ESOPs makes me a bit nervous. It isn't just the fact that *at most* 50 percent of workers' accounts can be invested in an asset outside of company stock. This lack of investment diversification pales in comparison to the fact that if one's only retirement plan is an ESOP, one's entire life would be non-diversified. One's salary, health insurance, and retirement accounts could all be tied up in a single company.

Luckily, this concern is somewhat misplaced. The reason is that – as Figure 1 below shows – most companies that sponsor ESOPs also sponsor another plan, typically a 401(k). Plus, some of the single-plan companies with an ESOP combine it with a 401(k) component into something called a "KSOP," an acronym for Keystone Savings and Profit-Sharing Plan. In a KSOP, employers provide their match through company stock, but the employee contributions can be invested more widely, increasing diversification.

Figure 1. *Distribution of ESOPs by Existence/Type of Other Offered Plans, 2022*



Note: Roughly half of the "other" category included a separate profit-sharing plan.
Source: Author's calculation from the U.S. Department of Labor Form 5500 Database (2022).

Put simply, in most cases, an ESOP is a complement to – not a replacement for – a more diversified retirement vehicle. If future policies encouraging ESOPs keep this balance and also encourage the adoption of 401(k)s, then ESOPs will continue to be a great way to help workers accumulate wealth while also encouraging ownership and empowerment.