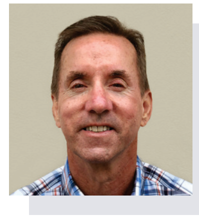
StockShield®

My Investment and Risk Management Strategies for Nonqualified Deferred Compensation

By **Andy Wagner**

Reprinted with permission from myNQDC.com, an online resource devoted to nonqualified deferred compensation



ABOUT THE AUTHOR:
Andy Wagner worked for his Fortune 500 company for over 32 years and has been retired for 4 years. He has been interested in personal finance issues since he chose an accounting major at the University of Virginia in the late 1970s. He is a Certified Public Accountant, and he earned an MBA in finance from the University of Chicago in 1983. Andy was a participant in his company's NQDC plan for 15 years, and elected to defer compensation in six of those years.

I work for a very large Fortune 500 company, and as a member of management, I have the opportunity to take part in its nonqualified deferred compensation (NQDC) plan. As a CPA, I am keenly aware of the benefits of tax deferral: delaying the paying of tax on my compensation until later in retirement. This benefit comes from the time value of money, as tax deferral gives me essentially an interest-free loan from Uncle Sam, and I can earn a return on that money in the meantime. If I pay taxes at a lower rate when I withdraw from the NQDC plan, my benefits are even greater.

This plan lets me put away more than I can with my 401(k) plan. However, the risk of corporate bankruptcy – and the potential loss of your nonqualified deferred compensation – is an important issue that you need to manage. Here is how I do it.

> "The risk of corporate bankruptcy – and the potential loss of your nonqualified deferred compensation – is an important issue that you need to manage."

Investments

A sophisticated investor will consider an entire investment portfolio as one, even if it is scattered across many separate accounts. This means you will view your IRA, 401(k), taxable account, and deferred compensation (both 401(k) and NQDC) as one unified investment portfolio. It doesn't matter that all of your bonds are in your IRA and all of your stocks are in your taxable account, as long as the overall portfolio is appropriately diversified according to your risk tolerance. An important principle behind this asset allocation concept is that fixed income investments act as an anchor to the portfolio, providing stability and safety during times when equities are buffered by recessions. Therefore, fixed income investments are typically quite safe and quite short-term—providing the security and stability during rocky times.

What investments should you put into your NQDC plan? I don't put "safe and secure" fixed income investments into it. Let's say you put risky equity investments in your taxable account, and hold fixed income investments in your NQDC plan. The economy dives into deep recession. Your stocks decline dramatically in value, but your fixed income holds its value. Suddenly, your employer declares bankruptcy

– and your “safe” fixed income investments are gone. You are laid off, and here comes the perfect storm. Your equities are very depressed and your fixed income investments have probably vanished (at the very best, they are tied up in a lengthy corporate bankruptcy). Just when you need the security of your fixed income assets, they aren’t available.

> I don’t put ‘safe and secure’ fixed income investments into my NQDC plan.

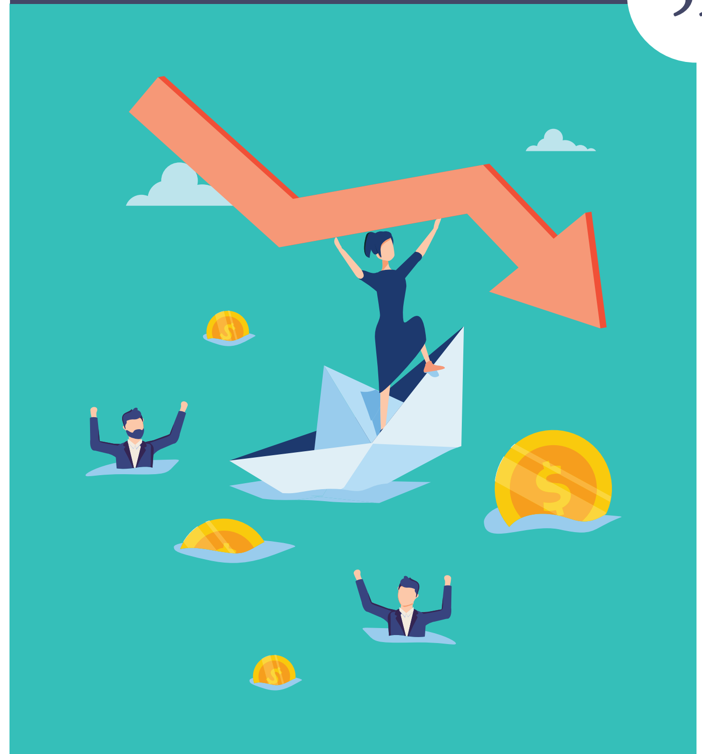
I manage this risk by investing in equities in my NQDC plan, while holding safe fixed income investments in my IRA and 401(k). The NQDC investments include international stocks, small cap stocks, and a REIT mutual fund. If you have flexibility to invest in equities in your NQDC plan, I encourage you to do so (and hold fixed income in other accounts). If your plan provides for only a fixed interest rate on your deferred compensation balances, I would be careful not to consider those balances as your “safe” fixed income investments. They may be fixed income, but they aren’t safe (from corporate bankruptcy).

Bankruptcy Risk

We all know about the bankruptcy risk of a nonqualified deferred compensation plan. And even though I work for a very large company, the examples of Enron, Lehman Brothers, GM, and BP show how even the largest and most respected firms can suddenly find themselves in (or in danger of) bankruptcy.

It is my belief that employees don’t always have the ability to see a corporate bankruptcy coming. Thus I believe it is dangerous to base your strategy for NQDC investments on an assumed ability to react before a bankruptcy. Even if you could anticipate a bankruptcy six months in advance, it is likely that nothing could be done to protect your funds in the NQDC plan and accelerate distributions (unless the plan is grandfathered). I would base any assessment of bankruptcy risk on your company’s financial strength, and then use the strategies I lay out below to manage that risk.

> Employees don’t always have the ability to see a corporate bankruptcy coming.



Here are three strategies I use to manage this risk.

1. Delay the deferral of compensation until later in your career. This shortens the period of exposure to bankruptcy risk. If you are in the middle of your career, consider using your income to fully fund a college 529 account, pay off your mortgage, or build up your taxable account. Then, as you get closer to retirement you can defer larger amounts of salary and bonus – but with a shortened period of exposure to bankruptcy. The downside of this approach is that you have less time for tax-deferred growth.

2. Set the withdrawal schedule for quick payouts. When you establish the NQDC payout period, choose a relatively short period (I choose my plan's minimum, which is five years). By choosing a longer payout period you simply extend the bankruptcy exposure. In reality, this may mean you have a larger portion of your retirement income coming from the NQDC in your early retirement years, and more coming from your IRA in later retirement. But this shouldn't present a tax problem, as both the NQDC payouts and the IRA payouts are taxable income to you. One disadvantage of this approach arises if you move to a state with a lower tax rate, as your former state may still tax you.

3. Limit the percentage of your assets in the NQDC plan. Given the potentially catastrophic consequences of a corporate bankruptcy, I set a limit on the percentage of my nest egg that can be in my NQDC. For me that amount is 10%, but the figure can be different for others. My logic is that I can tolerate a complete loss of 10% of my investments, without seriously risking my ability to retire (on my chosen timeline). But a total loss of a more significant share of my retirement investments would have more severe (and unacceptable) consequences.

I manage to that 10% target. I may have the ability to defer more compensation today, but I won't defer additional amounts if it will cause my NQDC balance to exceed the 10% target. As my non-NQDC balances grow (IRA, 401(k), taxable account), I gain more capacity in the NQDC, allowing me to defer in subsequent years. I do not set any other percentage limits for the amount of my contributions to the non-NQDC accounts, as they don't require management of bankruptcy risk. Thus I am not concerned with the percentage of investments in my 401(k) or IRA or taxable accounts, as the decisions to invest in those accounts are driven by other factors (tax deferral, income tax rates, company matching, investment options, costs, etc.).

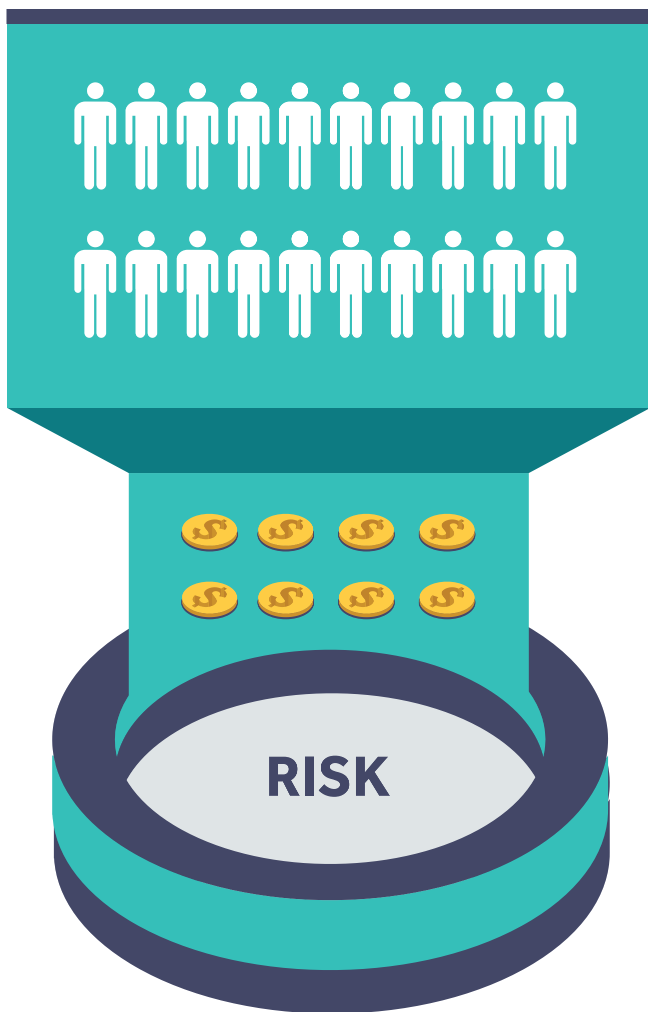
Balancing Benefits and Risks

All three of these strategies – delaying participation in the NQDC, setting an early payout schedule, limiting the balance in the NQDC – serve to reduce the benefit of tax deferral from the NQDC plan. However, I believe you should balance the benefits of tax deferral with the risk of corporate bankruptcy. The strategies that I follow serve to balance these two competing issues, while ensuring that I do get some valuable tax-deferral benefits from the NQDC.

In the situation that an NQDC participant finds themselves with too much of their assets in the NQDC plan, there are limited ways to mitigate that risk. This is because an employee generally must elect a set payout period – at the time of their initial deferral – and this decision can generally not be changed except to further extend the payment plan. Thus, shortening or accelerating the payout period are not options to reduce exposure in this situation.

> "One potential option is by pooling bankruptcy risk with participants in other NQDC plans, much like an insurance company pools the risks from different individuals."

While a participant can diversify their investments inside the NQDC, they cannot easily diversify away their exposure to bankruptcy risk. One potential option is by pooling their bankruptcy risks with participants in other company NQDC plans, much like an insurance company pools the risks from different individuals. A company offering such a plan is StockShield. They pool the bankruptcy risks of 20 participants, each in a different industry. Each participant makes an investment in a risk management trust and after a set period (five or ten years) the trust is terminated. If there are no bankruptcies, the trust pays back the investment to each participant (and this would mean the "insurance" was essentially free). If there is a bankruptcy, the trust pays the entire amount to that participant. This payout to the participant in the bankrupt company serves to offset the loss they face from the NQDC plan.



This StockShield arrangement isn't a perfect hedge against bankruptcy. The payout amounts don't necessarily match the actual NQDC loss that a participant may face, and a company may declare bankruptcy after the trust is terminated. And the StockShield trust isn't available for participants in companies that are on the verge of bankruptcy; it is for companies that are healthy today. Nonetheless, the ability to purchase an investment that serves to partially insure against bankruptcy risk is a valuable option and can be beneficial for participants who find themselves with too much bankruptcy risk.

> "The ability to purchase an investment that serves to partially insure against bankruptcy risk is a valuable option and can be beneficial for participants who find themselves with too much bankruptcy risk."

This content from myNQDC.com is provided as an educational resource. myNQDC.com shall not be liable for any errors or delays in the content, or any actions taken in reliance thereon. Copyright © 2019 myStockPlan.com, Inc. Please do not copy or excerpt content from this website without the express permission of myStockPlan.com Inc (contact editors@mystockoptions.com)

myNQDC.com