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THE COST OF OWNING EMPLOYER STOCKS: LESSONS FROM TAIWAN

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Employees at companies listed on the Taiwan Stock Exchange (TSE) hold a strikingly large proportion of their equity portfolios in their employers' stocks. For all employees at the 442 companies, 71 percent held their own employer's stocks at the end of 1998. The employer stock makes up an average of 47 percent of the value of the personal portfolios (the median is 42 percent).

Investor characteristics are important in explaining cross-sectional differences in employees' tendency to invest in employers. Employees who are older and those with higher incomes invest more in employers. When controlling for other investor characteristics, senior managers indeed invest about 3 percentage points less of their portfolios in employer stocks than other employees do. Employees at companies with high book-to-market ratio, larger market capitalization, and high-tech companies invest more in their employers.

Individuals suffer considerably from investing in employers. They do not gain abnormal returns by investing in the employer stocks. Instead, under-diversification resulting from the employer bias exposes individual portfolios to excessive idiosyncratic risks. If employees were to replace the 47 percent of their holdings in employer stocks with the market portfolio, they could obtain a higher return of 4.89 percent per annum, holding constant the current risk level. Over the 27-year horizon before the average employee retires, portfolios free from employer bias can generate a terminal value that is more than three times as large as individuals' observed choices. That is, the bias-free portfolio can sustain retirees three times as long as the observed portfolios, under the same spending pattern.

Such findings are particularly striking in Taiwan, where employees make investment decisions under far less influence from their employers or retirement plans than their counterparts in the United States. Our findings point out that some inherent behavioral biases are responsible for the persistent enthusiasm that employees display toward their employers. In addition, providing well-diversified investment alternatives is critical in maintaining portfolio diversification and safeguarding retirees' financial health. Finally, the findings from Taiwan provide useful lessons for social security reform in many other emerging markets where the mutual fund industry is not well developed.

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