

Bp amoco case essay sample

[Finance](#), [Investment](#)



1. In a defined-contribution (DC) pension plan, the employee or employer, or both, make regular contributions to the plan. In the US, employees typically set aside a predetermined percentage of their earnings which is deposited to the plan and the employer will match that contribution. Ultimately, the amount of money available to the individual upon retirement is determined by the performance of their investments. Each employee retains the option to choose how to diversify their investments, while the employer will typically provide a “ default allocation” option. The options available are generally very varied, and includes a number of index funds and actively managed mutual funds. In a defined-benefit (DB) pension plan, the retiree is paid a fixed amount per month upon retirement. That amount is calculated based on a formula that takes into account the employee’s past earnings, age and tenure. In this system, the employer assumes the risk while employee bear no risk. Funding comes from both employees and employers, and the fund can be managed internally or by an external fund manager, or a combination of both. 2. Amoco offered index-oriented investment options to its employees

. These investments, known as core investment options, were designed for Amoco employees and managed by professionals in a daily and passive fashion. This index funds had lower management costs. The average expense ratio for the indexed funds in the Amoco plan was 10 basis points. In addition, Amoco offered its employees externally managed index funds for US equities, long-term bonds, and US money market instruments. Amoco also offered a balanced indexed fund that mixed these three domestic asset groups plus international equities in a diversified portfolio. US Savings Bonds

were offered to Amoco employees as well. State Street Bank provided the trustee and record keeping services. In the years before the merger, Amoco included an international equity index fund, a mid-capitalization index fund, and a small-capitalization equity index fund. Another plan was offered that strictly invested in the company's stock. To reduce brokerage fees, this fund aggregated all investment activity by plan participants on a daily basis, matching buying and selling activity.

Participants could trade the company stock fund on any business day, but limited to only twice a month. In 1998, Amoco DC plan assets were valued at \$5.1 billion. 55.5% of the assets were invested in company stock. The rest of the assets were invested in equity index funds and the money market fund. The plan had 27,290 participants with an average of \$186,000 per participant, and contributions of about \$4,182 per year from each one of them. The company matched contributions up to 7% of pay. BP America had a different defined contribution plan. The company offered employees the opportunity to buy shares of company stock, invest in a stable income fund managed internally and seven public mutual funds. The mutual funds included three active funds on US equities, one active fund on international equities, two active balanced funds that invested on bonds and stocks, and one index fund. Plan assets were valued at \$2 billion, and the plan had 12,892 participants, making it smaller to Amoco's.

In contrast to Amoco's plan, only 16% of the assets were invested in company stock, and 51% of the assets were invested in the stable income fund. The rest of the assets were invested mostly in one of the equity funds.

Each participant on average had assets of \$156, 800 in the plan, and made annual contributions of about \$2, 824. The company matched this contribution with about \$1, 400 a year. Just before merging, BP had approved a plan to extend the number of investment options using fidelity investments as trustee and record keeper. This made more than 150 mutual funds available to the participants. 3. We recommend that BP Amoco offers a combination of index funds, mutual funds, and company stocks to their employees. The cost of these different investment options should follow the price-discrimination approach and the company should cover only the cost of core investment funds, leaving the cost of mutual funds to be covered by the plan participants.

We have decided to offer several index funds because they are low-cost and well diversified, meaning that they carry low risk. In addition, mutual funds should be included because they simplify the merging of BP America's and Amoco's pension plans. Even though mutual funds have a higher cost and carry with them an increase in liability for BP Amoco, not including mutual funds would mean liquidating or freezing existing investments in mutual funds for BP America's employees. The mutual funds offered should be evaluated based not only on the alpha, but also on the Sharpe Ratio. It is important to include the Sharpe Ratio in our analysis because it tells us whether the high returns only came as a result of higher risk, or if they were the result of smart investment decisions made by mutual fund managers. Although investing in company stock would mean that participants would have to bear all the risk, BP Amoco should offer company stock to its employees for several reasons. The first being that when investing in the

company's stock, brokerage fees are reduced significantly. The second reason is that employees can invest in their DC plan using their pre-tax income.

Another reason to include company stocks is that when BP Amoco matches the participant's contributions to their plan, they can use company stock to do it. This way, matching doesn't cost the firm cash and doesn't reduce the company's earnings. Finally, offering company stock is a way to match employees' performance to the overall goals of the company. 4. We would recommend different default allocation strategies for participants depending on their age. Because many employees hold on to the default allocation and do not make changes, the plan allocation should adjust over time automatically, otherwise the allocation will naturally adjust over time and stocks will make up too much of the portfolio in later years. When participants are young, it is recommended that they invest a higher percentage of their contributions in stocks (high risk, high return) and a lower percentage in cash equivalents (low risk, low returns).

When an employee is in his or her twenties, the default allocation recommended would be 10% cash, 40% bonds, 20% stocks, and 30% international stocks. This allocation has a higher return with higher risk, which is ideal for young investors since retirement is many years away. Middle-age employees should balance their short- and long-term goals at the time of allocating their investments. For example, parents should have enough liquidity to cover their children's education costs on time. By the time the employee reaches the age of 50, the allocation should be adjusted

to have a higher percentage in bonds than stocks, making the DC pension plan much less volatile and risky during the last decade of employment. If liability risk considerations were not at play, default allocation would be higher for stocks and lower for bonds.

If BP Amoco has no liabilities risk when its employees invest their pensions in stock markets, then it is optimal that the allocation favors stock markets when employees are young so that they can get higher returns. In this case, we would set default allocations at 10% cash, 20% bonds, 30% stocks, and 40% international stocks. Because 401k contributions are capped at \$15,500, many employees will save outside the 401k. They should allocate their investments depending on the tax rate of a specific asset. Long-term stocks are taxable only when they are sold. This means that tax is deferred until you sell a stock, giving you the possibility to cover your taxes with your capital gains. To accommodate these employees, the plan should be adjusted to include mostly stocks in order to defer taxes on capital gains until retirement. Outside of the plan, employees could then invest in long-term assets and liquidate them upon retirement. By following this plan, employees that will invest outside of the 401k will be able to minimize taxes on capital gains by deferring them until retirement, when they will be in a lower income tax bracket.