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The Pension vs. Lump Sum Decision

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Defined benefit pension plans are a rarity these days. They've largely been replaced by defined contribution plans, such as 401ks. But, if you have a pension and are on the cusp of retirement, you may have an interesting choice to make if you have the option to take your benefit as a lump sum. Let's review some of the factors that go into making the right decision.

Taking Benefits as a Pension

Let's start with the positives. First, pension benefits are a guaranteed source of income for life as long as the plan remains solvent. Even in the case of insolvency, for most plans, there is government protection up to certain limits.

Second, a pension may effectively address one of the key risks of retirement – longevity. This is the risk of living beyond your life expectancy, and therefore outliving your money. If you have a good track record for longevity in your family history, you should take a close look at the pension payout options available.

Finally, company defined benefit plans may provide better payouts than an annuity you purchase yourself through the marketplace. This depends on the formula the company uses to calculate the payout, which can be based on years of service, last level of salary and other factors.

Now, let's take a look at two of the major drawbacks associated with taking benefits as a pension. First, pension payments typically are not annually adjusted for higher costs of living, which results in inflation risk. In other words, you risk losing purchasing power over time.

Second, payout rates are near historic lows in today's interest rate environment. We define a payout rate as the amount of your annual pension income divided by the lump sum equivalent. For example, assume a 65-year old retiring today is offered a pension with an annual payout of $30,000 or a lump sum of $500,000. This equates to a payout rate of 6 percent, which may sound nice in today's low-yield environment. However, when measured against a conservative investment strategy with the lump sum, it takes a significantly long time to break even. For example, assuming a discount rate of 3.5 percent, that 65-year old might have to wait 25 years and reach age 90.

There are a couple more points worth noting about pensions. Spouses can be protected by electing a joint-life payout instead of a payout based only on your life. That is often a wise decision if you are taking the pension, but you'll have to accept an even lower payout to get that protection.

The downside of most payout structures is that pension income will end with your death or the death of your spouse. So if it's important to you to leave assets to your heirs, you'll have to consider this carefully. Once you make a decision to take your benefit as a pension, it is irrevocable.

Taking Benefits as a Lump Sum

Let's start with the positives again. First, you will have flexibility and access to the plan's assets. In most cases, you will rollover the lump sum amount into an IRA to maintain the tax deferral. If invested well, say with a balanced-risk portfolio of stocks and bonds, you could generate a similar type of income typically received with a pension through a systematic withdrawal plan. If you didn't want the burden of managing the money, you could hire an investment advisor. This route also allows for the potential to leave unused assets to heirs in the future.

Second, you can maintain the purchasing power of your assets by investing the lump sum properly. For example, consider the growth of dividends on S&P 500 companies over the last twenty years. This was not a particularly easy time to invest because you had both the tech bubble collapse and the Great Recession of 2008-09, but during this time period, the dividend dollar amount on the S&P 500 doubled. It grew at a rate of 3.6 percent per year, measurably higher than the rate cost of living grew during that same time period. We're not even talking about total return here, just the dividends. Remember, with a pension you're getting the same dollar amount every single year.

Another option is to take the lump sum, roll it into an IRA to invest and choose to annuitize when you are older or interest rates are higher. Age and interest rates are the two big leverage points for pensions and annuities. Unfortunately, neither is in the retiree's favor today.

Now, there is one main drawback to taking the lump sum. The tradeoff you're making by taking the lump sum over a pension is that you're agreeing, at least implicitly, to take on the investment responsibility and market risk yourself. If you're the type of person who can't or won't ride out the inevitable market downturns, you may be better off with the pension. That would be better than making the wrong investment or spending decisions that result in depleting your portfolio.

Conclusion

Making a good decision on whether to take the pension versus lump sum comes down to your personal situation, risk tolerance and propensity to invest. The decision will always be case specific.

In our view, investing in the markets is the ideal way for most people to build wealth. For our clients, generally, taking a lump sum is going to be the better choice. But for someone who doesn't have any interest in investing or hiring an investment advisor, the safest approach might be taking a pension. Given that pension plans are a dying breed, consider yourself fortunate to have the choice.

Sources

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