LUMP SUM OR PENSION?

Suppose you actually won the lottery. You are given a choice of $1,000 per month for the rest of your life or a lump sum amount of $200,000. Which do you choose?

Many employees face a similar decision when they leave a company that has a pension plan. Some, but not all, companies offer employees a choice between taking a lump sum (one-time) distribution vs. receiving a monthly pension. How do you decide which is better?

How Long Will You Live?

Well, of course you don't know, but this is certainly critical to making the decision. The longer you expect to live, the more attractive a monthly pension appears vs. a lump sum distribution.

Do You Need the Income?

What is your current and retirement budget? Do you need the monthly pension amount or would it simply be "extra" money, but not something you *must* have? If the pension is needed and it is part of your retirement budget, then the pension may be attractive. But, if Social Security, other pensions, continued employment, rental income, or other sources of income are sufficient, you may not require the pension.

What Would You Do With the Lump Sum?

If you did receive a lump sum, what would you do with the money? If your answer is to take a great vacation, open a restaurant, or loan it to your uncle – then for goodness sakes, choose the pension instead. Otherwise, you will most likely never see the money again and you will also be without a pension. The pension provides a predictable monthly cash flow and protects you from making a really dumb decision with a big pot of money. On the other hand, if you want control over your assets and believe you are smart enough to avoid restaurants and your uncle - then we can talk about the next point.

What is the Rate of Return?

Whenever I consult with a client on this question, I open my Excel spreadsheet and calculate what is known as an "Internal Rate of Return." This simply looks at the lump sum amount as if it was an investment that is generating a cash flow equal to the monthly pension. The internal rate of return increases each year, since your ultimate return depends on how long you will live. Obviously, if you should choose a lifetime pension and then die shortly thereafter, you made the wrong decision and your internal rate of return is negative. However, after some years, this return becomes positive, and the calculation provides me with a benchmark to measure investment decisions against.

For example, what if the internal rate of return, after 30 years of receiving the pension, was around 4%? This tells me that if my client is relatively risk-averse and is comfortable with a low-risk return of 4%, the pension is not a bad choice. But, if the client is a bit more growth-oriented, and doesn't mind some normal market risk, taking the lump sum and investing it in a sensible portfolio would likely generate, over time, a higher rate of return and be the wiser choice.

Avoid Taxes

If a lump sum is chosen, it is usually advisable to transfer the pension into an IRA and not receive it directly. Otherwise, the entire lump sum amount would be subject to income tax immediately.

Pension Options

If the pension appears to be the best choice, there are still decisions to make. If a person is unmarried and has no dependents, a “life only” pension might be selected. This pension would end at death. But, if a person is married, some form of “survivorship” option may be the better choice. This choice reduces your pension amount, but also provides for the pension continuing – in some amount – after your death.

In some cases, a married person might choose a “life only” pension but also obtain a life insurance policy. The pension ends when they die, but the life insurance policy can take its place. The “life only” pension provides for a higher monthly income, and the additional income can be used to pay the premiums on the insurance policy.

*Gerald A. Townsend, CPA/PFS/ABV, CFP®, CFA®, CMT is president of Townsend Asset Management Corp., a registered investment advisory firm. Email:*Gerald@AssetMgr.com