Pension Maximization: Lump Sum vs. Annuity

Which Is Right for You?

While it is no secret that pensions in the workplace are on the decline, many individuals who are still covered by defined benefit pension plans must decide whether to take the pension payout as a lifetime income stream or as a lump sum to be rolled over into an IRA. An individual must consider several factors before making this decision. These factors include rate of return, risk tolerance, life expectancy, marital status, interest rates, and the stability of the pension itself.

With regards to rate of return, an individual should work with his or her Stifel Financial Advisor to determine whether a higher rate of return may be generated from pension cash flows taken as an income stream or from a lump sum rolled over into an IRA. However, this rate of return comparison cannot be conducted in a vacuum. Instead, the individual and his or her Stifel Financial Advisor must also consider the individual's risk tolerance. Individuals with a higher risk tolerance may be better off making a lump-sum rollover to an IRA. This is due to the fact that those funds could be invested in various holdings with more inherent risk aimed at potentially generating greater returns. On the other hand, an individual with a low risk tolerance may be better off receiving the pension payout as a lifetime income stream. This is due to the fact that the internal rate of return for this lifetime income stream may be greater than the rate of return that would be generated by the conservative investments in the individual's IRA.

Other factors that must be considered are the individual's life expectancy, family medical history, and current health. Individuals who do not expect to live until their life expectancy due to poor health or a family history of premature death may be better off taking their pension as a lump-sum payout rather than as a lifetime income stream. On the other hand, those individuals in good health who come from a line of long-lived relatives may be better off taking their pension as a lifetime income stream. The life expectancy factor also highlights the importance of considering an individual's beneficiaries when making a decision regarding pension payout. If a person takes the pension as a single life income stream and passes away shortly after payments begin, the payments cease and his or her heirs receive nothing. If the individual takes the pension as a lump-sum payout, rolls it over in his or her IRA, and subsequently passes away, the balance of the IRA will be distributed to his or her beneficiaries as designated on the account.

The next factor to consider is the individual's marital status. Married individuals may have the ability to receive pension payments as a joint-life annuity. In other words, the pension income stream will continue until the death of the individual or his or her spouse. This option provides a safety net for the income stream option by minimizing the risk of an untimely death. However, under a joint-life payout, the payments are reduced to account for the fact that they are expected to last for a longer period of time, spanning two life expectancies. Due to the reduced payments, a couple has to live longer in order to achieve a similar internal rate of return as a single life payout structure. Furthermore, if both spouses were to die significantly earlier than their life expectancies, the lost benefit is even more substantial due to the reduced payments based on joint-life expectancy. To address this risk, many married couples will consider a pension maximization technique. The retiree can receive his or her pension as a single life payout in order to maximize the income he or she receives. The retiree can then use the difference between the income stream provided by the single life payout versus the joint-life payout to purchase a permanent life insurance policy. If the retiree meets an untimely passing after implementing this pension maximization technique, the life insurance will pay out to his or her designated beneficiary. The caveat with this strategy is that the retiree must be insurable.

Another factor that must be considered is the current interest rate environment. When interest rates are higher, the lump-sum payout tends to be lower. This is due to the fact that the discount rate used to determine the size of the lump-sum payout is higher. When interest rates are lower, lump-sum payouts tend to be higher. Accordingly, the rate of return generated by the lump sum does not have to be as high to meet or surpass the internal rate of return of the lifetime income stream.

Finally, an individual must consider the stability of the pension itself. Many pension plans are significantly underfunded. One state in particular has an unfunded pension liability of more than $100 billion. Private companies are routinely switching from defined benefit to defined contribution plans due to the unsustainability of their pension obligations. Accordingly, an individual must consider the ability of the pension plan to meet its obligations before making a decision regarding pension payout options. Since the Pension Benefit Guaranty Corporation (PBGC) backs most corporate pensions, individuals may be protected against default to a certain extent. However, the PBGC may cap the amount it will pay to an individual. This amount may be less than what the individual was receiving prior to default. Furthermore, The PBGC does not back any state or local government pensions.

As you can see, there are many important factors a retiree must consider before deciding whether to take his or her pension as an income stream or as a lump-sum payout. Factors such as rate of return, risk tolerance, life expectancy, marital status, interest rates, and the stability of the pension itself may all influence an individual's decision. There is no universally applicable strategy. All factors must be presented and considered, but in the end, this personal decision belongs to the retiree.