A FINANCIAL PLANNER BREAKS DOWN THE CHOICE BETWEEN A LUMP-SUM AND A PENSION RETIREMENT OPTION

By David Stubblefield, CFP®, CDFA™

Commerce Trust Company Senior Financial Planner David Stubblefield, CFP, CDFA, has vicariously "retired" more than 600 times – through writing individual financial plans for his clients. Since you are likely to retire only once, David would like to share what he's learned in a lifetime of retiring others. Doing anything hundreds of times more than others really does give you some perspective. So for you almost-retirees out there, put the worry beads down for a minute. Let David break it down for you so you can sleep at night.

Q. IF YOU ARE FORTUNATE ENOUGH TO BE FACING A CHOICE BETWEEN TAKING A LUMP-SUM RETIREMENT SETTLEMENT OR A STREAM OF PAYMENTS GUARANTEED FOR A LIFETIME, IS THERE A RULE OF THUMB TO MAKE THE CALL?

A. Yes, and I tend to take a simplistic approach that can be applied very quickly. I use the familiar analogy of comparing apples and oranges. Let's say the pension is the "apple" with an income stream you can't out-live and the lump-sum is the "orange" where you gain full control of your retirement fund, but also all of the investment risk that comes with managing it yourself. If they're offering me the orange, I have to ask whether they are giving me a big enough orange for the apple I'm going to give up, right? Is the lump-sum a good monetary offer? Now we need to apply a little math.

Q. SO FOR THE MATH-CHALLENGED, WHERE DO WE GO FROM HERE?

A. Again, let's keep it simple. Let's say we are talking about a married couple, and the retirees want to look at the 100% joint survivor option their company offers, a common choice. This is the pension option where you and your spouse are covered for your joint lifetimes. Let's say the lump-sum offer is $400,000 and the annualized pension stream is $25,000. In order to compare the two options, you take the estimated annual pension payment amount, and divide it by the lump-sum. The resulting interest rate calculation in this case is a little more than 6%. Then you ask yourself, is that a reasonable rate of return I can expect if I invest the lump-sum money myself? Maybe you are confident you can get that rate of return, and maybe you are not. 6% performance is not an unreasonable target for a well-managed portfolio. Theoretically, if you are successful from year-to-year, the lump-sum would remain at the end of your lifetime and you could pass it on to your children.

Q. SO THE APPLES AND ORANGES ARE COMPARABLE AFTER ALL?

A. It's all about what's a good value relative to the income stream the pension gives you versus what you can earn on the lump-sum yourself or via a third-party portfolio manager. At a 6% rate of return, the oranges and the apples are fairly even. But let's say that interest rate based on our simple calculation is 10%. To earn 10% on your lump-sum over time, you may have to seek very aggressive performance, either through your own personal management or via a third-party investment manager. Now you ask yourself if it's smarter to let your company take on the risk of making the lifetime payment to you and your spouse versus the lump-sum, which could be depleted over time if you fail to hit the 10% rate of return target. If your company has good financial prospects and your health outlook is good, why would you assume the inherent risk of managing a portfolio?

Q. OK, LET'S SAY YOUR CALCULATED RATE OF RETURN IS WAY LESS THAN 6%, WHAT THEN?

A. The potential for you or a third party investment manager to exceed the hurdle rate is very good long term. This is the opposite situation from the 10% scenario. Your likelihood of long term success should be much greater.

To summarize the hurdle rate analogy: 6% is a standard hurdle that can be jumped consistently with good management. 10% is a high jump or a pole vault. Something way less than 6%, say 3%, should be like stepping over a door threshold.

Q. YOUR RULE OF THUMB LOOKS LIKE A GOOD PLACE TO START. BUT WHAT ABOUT THOSE WHO REALLY WANT TO RUN THE NUMBERS?

A. They can do that with all the online "breakeven" calculators available today. I believe the most robust answer is to look at each option as it fits into your overall financial life, so you can make an educated decision. To do that properly may take a little time and may require a holistic financial plan.

Q. OK, LET'S TAKE A LITTLE MORE FOCUSED LOOK AT THE PENSION STREAM OF PAYMENTS OPTION.

A. So the pros of taking the pension would be its longevity – it's money you can't outlive. It's comforting to many knowing that the greater portion of their assets, expenses, and core expenses are covered through money they can't outlive. It can make the retirement transition easier for some because it gives them the feeling of a "paycheck" going forward. If you are in the enviable position of having additional savings, the regular stream of pension payments gives you flexibility with your remaining assets to perhaps increase your market exposure and grow those assets more in retirement.

Q. ARE THERE ANY CONCERNS ON THE PENSION SIDE?

A. Yes, and the biggest one may be the health of your company's pension plan. You want to make sure it's a good viable pension plan and fully funded. And remember that the pension choice is a generally a permanent decision.

Q. YOU MENTIONED THE 100% JOINT SURVIVOR OPTION FOR THE PENSION STREAM IN YOUR EXAMPLE. CAN YOU ELABORATE ON SOME OF THE OTHER PENSION PAYMENT OPTIONS?

A. If you are married, you will have some alternate annuity stream options that you can take with your pension. By law pension plans have to offer a 50% joint survivor option if you're married. A lot of plans will then offer variations of 50% joint survivor up to 100% joint survivor. So, for example, let's say my pension is $20,000 a year with a 100% joint survivor. While both my spouse and I are living, we will receive $20,000 a year. If I pass away, my spouse will continue to receive $20,000 a year. However, if we opted for 50% joint and survivor if I pass away, my spouse will receive $10,000 a year.

Q. OK, LET'S WRAP THIS UP WITH A LAST LOOK AT THE PROS AND CONS OF THE LUMP-SUM.

A. The pros would be you have full control of that money. It is yours to do with what you will. Hopefully you can grow it over time and then possibly leave it to your heirs. You have full liquidity and full power over that. The con is that with full power comes full responsibility, and the investment risk is all yours.

Q. THIS IS AN EMOTIONAL DECISION FOR FOLKS. THIS IS SOMETHING THAT'S GOING TO DETERMINE THE FINANCIAL COURSE MAYBE FOR THE REST OF YOUR LIVES, OR FOR THE COUPLE'S LIVES.

A. Truly it is, but it's something that can be logically put on paper in a financial plan with a qualified financial advisor, and that seems to take the angst out of the process for most people. It is a big moment in your life when you walk away from earning money and you have to shift to using the money you've been saving.

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David is a financial planner with Commerce Trust Company. He is a member of the financial advisory services team, a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client's unique situation and thoughts regarding wealth, David develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax, and investment strategies along the way. His areas of focus includes planning for financial independence, retirement, divorce, executive compensation, estate preservation, and business succession. David joined Commerce in 1995 and has held positions in private banking, credit analysis, commercial business development, and retail sales. David received his bachelor of science degree in business administration from Southeast Missouri State University. He holds both the CERTIFIED FINANCIAL PLANNER™ and Certified Divorce Financial Analyst™ designations. Additionally, David is a member of the Financial Planning Association and the Institute for Divorce Financial Analysts.