The pension decision: Lump sum vs. monthly

You have a pension, congratulations! Only 4 percent of employers offer a pension. Pensions are an endangered species compared to the 1980s when 60 percent of private sector workers had pensions.

Several companies in our state have recently restructured, creating many unexpected retirement transitions. Usually you are given a deadline and required to make major life-altering decisions in a matter of a few short weeks.

When the separation offer is voluntary, the office is buzzing with news of co-workers’ decisions and opinions. When a pension plan is involved, the opinions can be very polarizing. The pension decision is a one-time signature that will affect cash flow for the rest of your life. The multiple variables create complexity and indecision. We work through it with clients every week. Let’s work through it with you today.

Most people want to solve for this decision the way you would solve a math equation — assuming there is only one equation and one answer if you do the math correctly. The problem is, when it comes to pension decisions, there are multiple equations.

What equation are you solving?
- Highest payout rate
- Best inflation protection
- Greatest flexibility in the timing of withdrawals
- Largest inheritance for the next generation
- Lowest market volatility risk

Each one of these equations may lead you to a different pension decision. I have found that good data with relevant formulas can provide clarity to many decisions in financial planning. Let’s talk about the emotional (non-math) deal breakers first. Then let’s cover the math.

• Deal breaker No. 1: If my spouse and I die, I would HATE to not pass anything on to my kids.
  
  **Retiree inclination:** lump sum benefit
  For many, the lack of a death benefit will trump all factors. They cannot accept the possibility of not passing assets to the next generation in the event of an early death. Other retirees would like their last check to bounce as they lay down in the coffin.

• Deal breaker No. 2: I am so scared of investing, if I took the lump sum, it would be under my mattress.
  
  **Retiree inclination:** monthly benefit
  There is no shame in being Nervous Nellie, however, be self-aware. You need to earn a certain rate of return with your pension lump sum. Money market rates at your bank are not likely to cut it.

• Deal breaker No. 3: I am done being affiliated with my employer.
  
  **Retiree inclination:** lump sum benefit
  You don’t always leave on the best of terms. This is especially true if you wanted to work longer and are being forced
out. Some want to avoid any affiliation whatsoever. This is not necessarily the best state of mind in which to make lifelong decisions, however, it can be a deal breaker for some.

- **Deal breaker No. 4:** I have never been great with spending and worry I’ll spend through it too quickly.

  **Retiree inclination:**
  - monthly benefit

  A spendthrift individual may benefit from the rigidity of the monthly pension. Conversely, we have found the lack of flexibility can inhibit some tax strategies.

  There are other emotional deal breakers, however, let’s move on to my favorite part, the math.

  This is Rochelle’s pension information. Who is Rochelle? The most surprising name on the list of top 10 names for females in 1954. Whose pension info is it? A retiree who met with me in May of 2019. Rochelle’s pension basics:

  | Age at Pension Start | 65 |
  | Lump Sum Amount      | $356,000 |
  | Monthly Benefit      | $1,800.00 |

  Let’s assume Rochelle chose to roll the $356,000 to an IRA. She would pay no taxes upon the rollover. She would pay taxes as she withdraws. How would the lump sum do if Rochelle chooses to withdraw exactly $1,800 per month (the same as her pension would have paid)?

  Here is where most do the math incorrectly.

  **Bad math No. 1**

  Don’t calculate the number of months left simply by dividing $1,800 in to $356,000. You are missing the effect of growth on your lump sum.

  Don’t divide one year’s worth of payments ($21,600) by the lump sum ($356,000). This is a 6.1 percent payout rate, but some of that is your principal and some is interest.

  \[
  \frac{1,800}{356,000} = 0.0050774647
  \]

  \[
  \times 12 = 0.0609295333
  \]

  \[
  \%
  \]

  **Required Rate of Return**

  The required rate of return – which I am going to call RRR from here on out – is what Rochelle really wants to know. In other words, what investment growth is needed on her lump sum to match the monthly benefit exactly? She needs to know the date she will die. Conveniently, we financial planners are notorious for providing the exact day. Rochelle will die exactly at 90. Her RRR is 3.9 percent. If she earns 3.9 percent on the $356,000 lump sum, her $1,800 per month will last exactly to 90 years old.

  **Okay, full disclosure, we don’t know the day of Rochelle’s demise. However, this chart shows all ages. If she passes away at 85, she only needs to earn 2.1 percent on her lump sum balance to match the $1,800 per month monthly benefit. If she lives to 100, she needs to guarantee she will earn 5.4 percent just to break even.**
Inflation is often misunderstood. Inflation affects a steady $1,800 per month withdrawal from a lump sum benefit the same way it would affect a monthly pension. Rochelle’s $1,800 per month pension will be worth this much in the future:

<table>
<thead>
<tr>
<th>Years</th>
<th>2% Inflation</th>
<th>3% Inflation</th>
<th>4% Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>$1,471</td>
<td>$1,327</td>
<td>$1,197</td>
</tr>
<tr>
<td>20</td>
<td>$1,202</td>
<td>$979</td>
<td>$796</td>
</tr>
<tr>
<td>30</td>
<td>$982</td>
<td>$722</td>
<td>$529</td>
</tr>
</tbody>
</table>

The lump sum benefit can combat inflation if Rochelle beats her RRR. If she beats the RRR, she could choose to either spend more per month or have more left over.

What if Rochelle was confident that she could earn 6 percent per year? The blue shows her lump sum balance if she earns her expected rate of return (6 percent) while withdrawing $1,800 per month. The green shows her lump sum balance if she only matches the RRR (3.9 percent).

Summary
Consider the math and the emotions. Not all decisions can be made through solving a math problem — believe me, I have tried. You might decide you relate to one of the deal breakers and none of these charts matter.

If you are interested in seeing these charts adapted to your pension figures, you can get a free personalized pension analysis report at thefinancialcall.com/pension-analysis/. The report looks like this:

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Reference: