

# Should You Take a Lump Sum Payment from Your Pension Plan? A Trap for the Unwary!

By Steve Vernon, FSA

Steve recently published *Recession-Proof Your Retirement Years*, which describes ten steps to survive future downturns and thrive in your later years. Here he provides details on one of these steps—making the best choice for benefits in traditional defined benefit plans. For details, see [www.restoflife.com](http://www.restoflife.com).

Suppose you're in your fifties or sixties and have worked 10 years or more for an employer with a *tax-qualified* defined benefit pension plan. Such a plan promises you a lifetime monthly retirement income (a.k.a. an annuity), with the option to continue the lifetime income to a surviving spouse or beneficiary after you die. You've earned some serious retirement bread—congratulations! Now suppose you're offered a lump sum payment in lieu of the annuity, either as a regular retirement or a special buyout. Should you take the money and run?

If you're like many people who get this offer, you don't think too hard about this. The obvious answer: Take the boatload full of money! After all, that's what your work buddies have done, and that's what many investment advisors recommend.

I worked for 35 years as a consulting actuary, helping large corporations design, manage and communicate their retirement programs. Whenever I saw a lump sum buyout offer, acceptance rates varied from 50% to well over 90%. This made me shake my head in frustration, as often I felt it was the wrong decision.

Now don't get me wrong. In some instances a lump sum is the right decision. But too often people choose it for the wrong reasons. This article addresses common myths and explains the pros and cons, to help you decide what is one of the most important financial decisions you will ever make. You'll live with this decision for 20, 30 or 40 years, so it's well worth the minutes spent reading this article and thinking about the issues.

## Your Big Challenge

When you retire, you want to generate a retirement income that will last the rest of your life, no matter how long you live and no matter what happens in the economy. If you're married, this income needs to last for both of your lifetimes.

Many people don't understand the risks and challenges with this goal; they underestimate how long they will live, they don't have adequate plans for dealing with market downturns, or they don't have a systematic method to draw down their retirement savings so that they don't outlive their money.

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Your first goal should be to avoid outliving your money and becoming a burden on your children and society. If you're married, you don't want to die first and leave your spouse with inadequate financial resources. Here are some scary statistics: For one-fourth of unmarried elderly women, Social Security is their only source of income, and one-sixth of elderly widows have incomes below the poverty level.

### **Misperceptions and Myths**

Often I see brokers and financial advisors target the employees of companies that offer lump sums, and they can be quite persuasive in favor of lump sums. Watch out if they automatically recommend the lump sum, and don't explain the pros and cons of each choice. They have a vested interest if they want you to invest your money with them; they aren't in a position to provide unbiased advice. Even if they are truly unbiased, what is their expertise? Many advisors are good with investments, but they aren't skilled at delivering and sustaining a lifetime retirement income, which is a different problem.

Often I hear myths that are 'reasons' for taking a lump sum.

*Myth #1.* If you take an annuity and you die soon after you retire, your employer wins and your heirs get nothing. If you take a lump sum, your heirs are the winners, not the company. This is the scary 'what if you get in a car crash' scenario, but it shouldn't be a deciding factor in your decision.

*Reality.* If you believe this myth, then electing a lump sum is a bet that you'll die soon after you retire. Do you want to win this bet? If you take an annuity, you're betting that you'll live a long time. Would you rather win this bet? Most people are more likely to live a long time than die soon after retirement. If you're married and elect the surviving spouse annuity, both of you have to die soon under the 'car crash' scenario; this is very unlikely. Base your decisions on what's most likely to happen, with contingency plans in case unlikely events happen. If you are considering an annuity but are worried about dying early in your retirement, the contingency plan is to elect a form of payment that continues the annuity to a spouse or beneficiary after you die, or to buy life insurance. If you take a lump sum, you'd better have a strong contingency plan for living a long time!

Finally, consider the consequences of losing these bets. If you choose the lump sum, you lose if you live too long and run out of money before you die. Bad outcome for you, bad for your spouse if he/she outlives you, and even worse for your children who might need to support you! If you choose the annuity and lose by dying soon after you retire (and with no beneficiary election), only your heirs lose. And besides – you're dead! Will you really care? Which consequence is worse for you? For me, losing the lump sum bet is much worse than losing the annuity bet, and losing the lump sum bet could be disastrous for my spouse and my children!

*Myth #2.* Lump sums are calculated using low interest rates (in the 4% to 5% range for 2012). You can easily beat these rates through investing in the stock market, which has averaged over 8% per year over the long run.

*Reality.* Yes, lump sums are calculated with low interest rates. So what? Have you paid attention to the stock market lately? It doesn't earn a steady 8% each year, and often goes down, sometimes by a lot. If you rely on your lump sum for retirement income, 'market volatility' can be another phrase for 'I need to go back to work.' If you take a lump sum payment, make significant withdrawals of principal soon after you retire, and the stock market declines, then you might not have enough assets to recover.

In addition, the interest rate is just one factor in determining lump sums. Longevity is also an important factor; lump sums are calculated assuming your longevity will be about average compared to men and women your age. If you take a lump sum and live longer than average, you lose. How hard is it to beat the average life expectancy? It's not rocket science—eat right, exercise, don't smoke, manage your stress. If you are in good health and take care of yourself, a lump sum may not be a good idea.

*Myth #3.* Most pensions are fixed, and aren't indexed for inflation. In 20 or 30 years, your pension won't buy a bag of groceries. You're better off taking the lump sum and investing it in stocks, where you have a chance of keeping up with inflation.

*Reality.* This myth actually has some elements of truth to it, but you need to think a little harder before using this as a reason to take the lump sum. Yes, it's true that most pensions aren't indexed for inflation. And yes, if you *successfully* invest in stocks over the long run, if you avoid market declines early in your retirement, and if you prudently withdraw from your assets so that you don't outlive your resources, there's a chance you might be better off. But these are big *ifs*, and they can leave you vulnerable to mistakes.

One way to deal with inflation is to maximize your lifetime retirement income, which often happens with the annuity as you'll see later in this article. Also, you can take the annuity and still protect yourself against inflation; here are some strategies:

- If you have 401(k) accounts and other retirement assets, or own real estate, consider them as your hedge against inflation, and invest them appropriately.
- If your pension is fixed and you want to give yourself future increases for inflation, use a strategy that invests part of the payments in your first years of retirement into a special cost-of-living adjustment (COLA) account, which then funds future pension increases. Here's how this works: In the first year, spend only 75% of your monthly pension and invest the remainder in the COLA account. After one year, increase the

amount you spend by 2.5% and keep investing the difference into your COLA account. Keep doing this until the amount you spend each year hits the total amount of your monthly pension and there's nothing left over to invest. Thereafter, use your COLA account to pay for the 2.5% increase in the amount you spend each year. Invest your COLA account in a prudent mixture of stocks and bonds.

*Myth #4.* What if your company goes belly-up; won't you lose your pension? You've probably seen the scary headlines—American Airlines was the most recent. Three things must happen for you to lose part of your pension.

1. Your company must go bankrupt. What's the likelihood of that?
2. Your pension plan must be underfunded when your company goes bankrupt, meaning that the plan's assets are well below the plan's liabilities. If the plan has assets in excess of the liabilities upon bankruptcy, you should be ok since the assets are in a trust that the company and creditors can't touch. You can get an idea of your plan's funding status by looking at the plan's financials; ask your HR department for help.
3. If your company goes bankrupt *and* its pension plan is underfunded, then the Pension Benefit Guaranty Corporation (PBGC) guarantees your pension. The PBGC is a federal agency that is like the FDIC for pensions. The maximum monthly benefit that is 100% guaranteed is \$4,653 if you retire at age 65 in 2012 and elect a life annuity. This amount is reduced if you retire before age 65 or elect a joint and survivor annuity. For example, if you retire at age 55 during 2012 and elect a life annuity, only \$2,094 per month is guaranteed. Also, if the plan sponsor adopted benefit improvements in the last five years, the amount of improvement may not be guaranteed. The PBGC guaranteed limit is increased in future years as average wages increase. The bottom line is that you're at risk only if your monthly pension is much bigger than the maximum guaranteed amount.

*All three* of the above events must happen for you to lose part of your pension (the amount over the PBGC guarantee). So, what is the likelihood of that? For most people, the odds are very small, but if you're worried about this, it pays to analyze your situation. See [www.pbgc.gov](http://www.pbgc.gov) for more information on guaranteed benefits.

*Note*—the above arguments apply to *tax-qualified plans*, which cover most workers, and not *nonqualified* plans for executives and highly paid employees.

These myths are perpetuated without considering the case for annuities by lots of people—the media, irresponsible brokers and advisors, or regular folks who simply haven't given it very much thought. *Don't follow the crowd – think for yourself.* Base your decision on reality, not myths.

### **An Example**

It helps to look at an example. Let's assume that you're retiring at age 65, and have earned a monthly pension of \$1,000, payable for your life. Using conversion factors that are in effect for 2012 for many pension plans, you would be offered a lump sum of roughly \$152,000. For most people, a lump sum of \$152,000 sounds like a lot more money than \$1,000 per month—but is it? Let's see what happens with each scenario.

If you elect an annuity, it's pretty simple. You get \$1,000 per month until you die, no matter how long you live, in good markets or bad. If you want to continue income to your spouse after you die, you can elect a joint and survivor income, with a lower monthly income. In the above example, if you have a 65-year old spouse, you could elect to receive about \$850 per month until the last one dies.

Instead, suppose you elect the lump sum. Now you need to invest this money to generate a retirement paycheck for the rest of your life, no matter how long you live. Suppose you think—I could have received \$1,000 per month with the annuity, so I'll take the lump sum and withdraw \$1,000 per month. With this strategy, what are the odds of running out of money before you die (aka the odds of ruin)? It depends on a number of factors—how you invest the money, whether you're a male or female, and whether you're married.

We can estimate the odds of ruin using Monte Carlo simulations, which is a sophisticated methodology normally used to help pension plan sponsors set investment and funding policies. If you invest in a diversified portfolio of stocks and bonds, the odds of ruin are more than one in four for a single man, and more than one in three for a single woman. If you're a married couple and withdraw \$850 per month, the odds are more than one in three that one of you will outlive your money. The odds get much worse if you invest with an unscrupulous or incompetent advisor, as you frequently see in the newspapers lately. The odds also get worse if you're healthier than average.

Ouch, these aren't good odds. You want to make sure that you don't outlive your money. One out of three or four are bad odds for such an unpleasant outcome; I'd much rather have odds of at least one out of 10. To get odds like that, you'd have to substantially reduce your withdrawal—well below \$1,000 or \$850 per month that you could have received if you took the annuity (which has virtually no chance of running out of money).

What's happening here? With the lump sum, successfully managing your assets so that you don't run out of money before you die means ... that you die with money left over. Money that could have been spent while you were alive, but you didn't because you were correctly paranoid about running out of money. But with the annuity, every last drop of principal is used to fund retirement income. This is why we say that an annuity is best at maximizing lifetime retirement income.

### **Pros and Cons – A Checklist**

When does an annuity make sense? Check the circumstances that apply to you.

- If you or your spouse are in good health, and maximizing your lifetime retirement income is important.
- If you're unsure of your investing abilities, particularly when you're in your 80s or 90s. One advantage of an annuity is that it's user-friendly. The check comes each month in the mail or is deposited electronically. Also, you don't need to invest the money, and be subject to market volatility or unscrupulous or incompetent advisors.

When does a lump sum make sense? Check the circumstances that apply to you.

- If both you *and* your spouse are in poor health.
- If maximizing lifetime retirement income isn't important to you, and if, for the rest of your life, you can invest successfully and live on prudent withdrawals from your lump sum—3% to 4% per year.
- If you have a purposeful strategy to live on just the interest and dividends so that you can leave the principal to children or charities when you die (you may not need to do this if you have other substantial assets to leave in your estate).
- If you can use the lump sum to buy an annuity from a solid insurance company, where the monthly income is much higher than the amount payable from your pension plan. See [www.immediateannuities.com](http://www.immediateannuities.com) for online estimates of annuity purchases.
- If you're so pessimistic about the future that you believe your company will go bankrupt *and* that the PBGC will renege on their promises.
- If you have other assets that are so substantial that it doesn't matter if your lump sum is depleted (Bill Gates wouldn't sweat this decision).
- If your lump sum comes from a *nonqualified* plan, and you're concerned about the ability of your employer to pay your pension for the rest of your life.

### **Seek Professional Advice**

If you're offered a substantial lump sum payment, you're best served by a competent, unbiased advisor who can help you make an informed election. Avoid advisors who have a vested interest in your decision, which usually means that they want to invest your lump sum for you. You also want them to have the necessary skills and experience to help with your decision; look for Certified Financial Planners, Chartered Financial Analysts, or credentialed actuaries (members of the Society of Actuaries or Enrolled Actuaries) who have experience with analyzing pension and life insurance benefits.

### **Some Final Thoughts and Strategies**

Consider your decision in the context of your total financial situation. Do you have substantial assets in 401(k) plans, IRAs, home equity or other investments? These can be your hedge against inflation, or your gifts to charities or children (although if you leave large amounts in 401(k) plans or IRAs, you need careful estate planning). If you have a substantial annuity, consider it as the conservative ‘bond’ portion of your overall portfolio, and invest your other assets for growth and protection against inflation.

Most people are familiar with the concept of asset diversification—don’t put all your eggs in one basket. Another version of this for retirees is income diversification; spread your risks by getting income from Social Security, from a lifetime annuity with your pension plan, and draw from 401(k) plans and other investments.

Still undecided? Some plans let you take part of your benefit in a lump sum, and part in an annuity. If you have this option and you’re still conflicted, consider a 50/50 split.

I urge you to carefully consider the pros and cons of this choice. People who elected a lump sum before 2008-2009 and invested it in the stock market are really hurting now.

Review the checklists on the previous page—which boxes did you check that apply to you? It may take years to realize if you made a mistake, and by that time, you probably can’t push rewind on your life and finances. Nobody wants to be a burden on their children or society, or to put their spouse at risk. Seek unbiased and competent professional advice if you’re confused, which, by the way, describes most people. Take the time to educate yourself and make an informed decision.

### ***Don’t bet your life!***

Steve Vernon has spent 35 years as a consulting actuary, helping large employers design and manage their retirement programs. Now he is President of *Rest-of-Life* Communications, where he provides unbiased, trusted information about retirement.

Steve’s most recent book is titled *Recession-Proof Your Retirement Years: Simple Retirement Planning Strategies That Work Through Thick or Thin*. Also, he recently produced an engaging and informative DVD/book combination titled *The Quest: For Long Life, Health and Prosperity*. For more information on both of these works, including purchasing information, visit [www.restoflife.com](http://www.restoflife.com).

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