Should I Take the Commuted Value of My Pension?

Sheila has just accepted a new job. Jon is retiring. They both have Defined Benefit pensions with their current employers and now they have to choose … either:

1. Leave the benefit in the pension plan and collect a pension from the Plan at retirement, or;

2. Transfer the lump sum commuted value to a personal locked-in retirement account.

How does one decide?

Sheila and Jon each face a serious, and difficult, decision. So many factors depend on their personal situations, and are outside their control. Getting professional advice is a good idea, but Jon wonders if the advice is truly unbiased. After all, his lump sum is rather attractive, and could generate hefty fees.

This is a complicated decision, but it can be boiled down to a few basic considerations:

1. **Investment return**: Lump sum commuted value calculations are based on an assumed investment return, right now around 3 or 4% per year. Jon and Sheila need to find out what was used in their calculations, then consider how they will reproduce that return year after year. Also, who will manage the investments, and at what price?

2. **Mortality**: A pension is paid as long as the recipient is alive (and often to a spouse or partner too, if they outlive the recipient). For the lump sum, the grim reality is that the owner will die before the money runs out, or after. It is pretty rare for someone to die on the day he spends his last penny. This becomes much more real at higher ages, when it makes a huge difference whether one has one year, or ten, left to live. (See our blog: You Have to Oversave).

3. **Asset mix**: What other assets are set aside for retirement? Jon just has his pension, so he has to consider how much risk he wants to take with it. Sheila has other savings, so a pension would add to the fixed income portion of her portfolio, allowing her to take more risk with her other assets. Both need to think about their pensions in terms of diversification of their retirement assets.

4. **Other benefits and concerns**: Some employers provide inflation protection or post-retirement medical benefits to pensioners, but not to those who withdraw the lump sum commuted value. On the other hand, pensions can be affected in bankruptcy cases, although pension legislation provides significant protection to members of pension plans where the plan sponsor is solvent. Both Jon and Sheila will want to make sure they've understood and factored in everything.

Crunch the Numbers

Let's consider Jon's decision for a minute. Here's a simple way he could crunch the numbers …

1. **Calculate the after-tax lump sum:** First, Jon needs to know the total amount he'll get from the lump sum, AFTER taxes. A portion of Jon's lump sum is taxable, so he needs to deduct taxes. Jon's lump sum is $500,000, after all taxes.

2. **Find out how much annuity the lump sum will buy:** Jon's next step is to call a few life insurance agents (or do an online search) and find out how much his $500,000 could buy him as a lifetime income annuity, with the same death benefits and inflation protection that he's getting from his employer's plan.

3. **Compare the annuity to the pension:** Finally, Jon compares the annuity quotes to his pension from the plan, and picks the option that gives him the highest monthly income.

What about Sheila? She's not retiring yet, so she uses a slightly different approach:

1. **Calculate the after-tax lump sum:** Sheila's after-tax lump sum is $100,000.

2. **Project the after-tax lump sum:** Sheila needs to project her $100,000 forward to her retirement age. For this, she has to make an assumption about investment return. If she assumes much more than the 3 or 4% used in the lump sum calculation, the lump sum option will look good no matter what. So, let's use a pretty realistic 4% based on a conservatively balanced portfolio of stocks and bonds. Sheila is 10 years away from retirement. $100,000 plus 4% compounded for 10 years gives her $148,000. Sheila decides to round to $150,000.

3. **Expected retirement income:** Sheila needs this to be simple and, based on her expected return of 4%, a good rule of thumb is to have savings equal to about 25 times the income she wants. This means that Sheila's $150,000 could pay her $6,000 per year ($150,000 divided by 25), or $500 per month.

4. **Compare to the pension from the Plan:** Now Sheila just needs to compare the $500 per month to the pension her employer's plan is promising (keeping in mind that the pension may have additional value in survivor benefits, inflation adjustments and other such benefits).

Yes, I have a Bias

I'm actually a big proponent of erring on the cautious side and taking the pension. The basic considerations above provide significant food for thought:

- **Investment return:** Don't overestimate how well the markets will treat you. A 4% return may seem an easy target, but in early 2000, 6% looked like an easy target (and it wasn't).

- **Mortality:** Who wants to spend their retirement worrying about when they're going to run out of money?

- **Asset mix:** A Defined Benefit pension can give better returns than many other fixed income investment choices like bonds or GICs.

At the end of the day whatever decision Sheila or Jon make will probably not be perfect. They both need to take their time, weigh all the factors, think long term and be wary of advice that's biased in the advisor's favor.

http://www.retirementworks.ca/theworks/blog052018a-Commuted-Value.html

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