Op-Ed: Should I take my pension buyout offer?

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As employees covered by defined pension plans approach retirement, companies are looking for ways to remove themselves from their obligations by offering pension buyouts. For example, instead of providing the retired employee with an income stream for life, the company may offer the retired employee a lump sum instead.

To some retirees, that lump sum can be quite enticing. After all, the lump sum is going to appear as a much larger number than the monthly pension benefit and it provides the retiree with 100% control over how and when to take withdrawals. Want more money now and less later? You can do that if you opt for the lump sum. And, if you and your spouse do not exhaust all your retirement assets, you can leave them behind to children and/or grandchildren. One drawback to the lump sum option is that with 100% control, you have 100% responsibility. You'll have to decide where to invest that lump sum, which may include putting some of it at risk in the market.

With a pension, you don't have the option to make your own investment choices, which could be good or bad, depending on your preferences. A pension is simply less flexible. Typically, you can't increase or decrease your monthly benefits based solely on your lifestyle. If you needed extra for a vacation or major medical expense, you will not be able to simply draw extra from the pension for those things. And, if you and your spouse become deceased prematurely, there is usually no remaining benefit for your beneficiaries.

These are important things to consider when given the option to take a pension lump sum buyout. Here are 4 more specific things you can do to evaluate the attractiveness of your lump sum offer.

1. Compare using a 4% withdrawal ratio

In order to evaluate your offer, you need to compare apples to apples, as opposed to comparing an income stream amount to a lump sum. So, you'll want to find out about how much income your lump sum would provide so that you can compare that to your pension benefit.

For example, let's assume your lump sum offer is $750,000. "The 4% withdrawal rule" is an approximate rule of thumb stating that by maintaining a moderate portfolio, you can essentially withdraw 4% of your portfolio in the first year, adjusting for inflation each year, and avoid running out of money for 30 years. While the 4% withdrawal rule has its limitations, it may be a good place to start.

According to this rule, a lump sum offer of $750,000 would provide $30,000 per year in the first year. You can then compare this number with your pension benefit. Which is higher? Does your pension offer inflation? Of course, keep in mind that if you invest the lump sum in the market, your income is not guaranteed, while your pension may be guaranteed (unless the pension fund is in danger of being depleted; see item #3.)

2. Compare using an income annuity

It seems there has never been a shortage of bad press for annuities of all kinds. And, because there are so many types, it's difficult to make a blanket statement about annuities, just as it is difficult (or even impossible) to make a blanket statement about any type of investment.

However, similar to a pension, an annuity can also provide a lifetime income stream. And, if you want to see if you can improve upon the pension benefit being offered, annuities are one place you could research. With an immediate annuity, you can start taking income right away. Deferred annuities can allow your benefit to grow until you begin taking payments. For risk averse investors, fixed annuities allow you to avoid the volatility of the stock market, but you should be prepared to give up some control and liquidity if you purchase one.

Nevertheless, when you're presented with a lump sum buyout offer, looking into what your income benefit could be through the use of an annuity is likely a prudent move.

3. Check the funding status of your pension

Regardless of how the math shakes out, you'll always want to look into the strength and funding status of your pension to get an idea of the likelihood that you will actually receive your stated benefit. In some cases, your pension benefit may mathematically blow the lump sum out of the water, but if the pension is unhealthy or not on track to be fully funded, that could be a major cause for concern.

There is no magic percentage that tells you if the pension will fail, but some industry experts have historically used 80% as a benchmark. However, this article from the American Academy of Actuaries disputes the 80% funding standard and points to several other factors instead like:

- Size of the pension obligation vs. the revenue, assets, and payroll obligations of the plan sponsor
- Financial health of the plan sponsor (measured by cash flow, total debt, and profitability)
- Funding or contribution policy
- Investment strategy, including the level of investment volatility risk and the possible effect on contribution levels
- Contribution patterns and overall projection of contributions vs. withdrawals

Some of this information may be difficult to obtain, but it should certainly be part of your evaluation process with such an important decision.

4. Evaluate your health

Lastly, your health could play a major role in whether to take a lump sum or not. Most of us don't know how long we'll live, but there are things that can help us gain an estimation (like our health history, family history, etc.). Of course, if you are married, you'll need to not only evaluate your own life expectancy, but also the life expectancy of your spouse, who would likely be receiving survivorship pension benefits.

If you are not in good health and don't expect to live to a normal life expectancy, and you are not married, a lump sum may allow you a chance to leave an inheritance for your children or other beneficiaries.

Bottom line

Clearly, the decision to take a lump sum or not is extremely crucial to your financial plan. There is certainly not a one-size-fits-all approach when evaluating your options, but these are all things to consider in your due diligence. And, if you enlist the help of a financial advisor, be sure that advisor is willing to recommend that you keep the pension, even though that might mean less compensation for them.

serve as market indicators and do not account for the deduction of management fees or transaction costs generally associated with investable products, which otherwise have the effect of reducing the performance of an actual investment portfolio.