Should I Take the Pension or the Buyout?

Case Study: George & Olivia Olsen

Background

George Olsen spent his entire professional career working for a major automotive manufacturer while he and his wife, Olivia, raised their two children. At the age of 65, he retired and started to receive an annual pension of $45,000. Upon George's death, Olivia would receive 50% of George's pension for the remainder of her life. Now, at the age of 76, his former employer has given him the option of receiving a $425,000 lump sum in lieu of taking his annual pension as scheduled. George and Olivia are not sure which option is best for them. George is in fair health and thinks that he should be able to live to age 85. Olivia, who is also 76, is in good health and expects to live to age 90.

Problem

Would George and Olivia benefit more from taking the lump sum buyout option, or should they choose to continue receiving the annual pension?

Solution

The first step in the analysis is to define the breakeven point for the pension versus the lump-sum buyout. If George and Olivia were to invest the lump sum in a conservative manner, the expected rate of return for their portfolio would be around 4% given today's low interest rate environment. If they invest their pension funds in a like-fashion, the breakeven point can be calculated on the graph on the next page. The graphs cross at age 91, suggesting that if they both were to die before age 91, they would be better off with the lump-sum.

Next, we have to consider their risks. If they continue to take the pension, Olivia runs the risk of George dying early which would cut her pension payout in half. Another risk consideration is if either of them live beyond the age of 91. With a 4% interest rate assumption, this suggests it would be better to take the pension. However, if they have other investment assets which would allow them to take on more risk and thus earn a higher return on their investments, the lump-sum option may be better. Finally, if neither lives beyond age 91, the pension stops and their heirs would not benefit. On the other hand, any funds remaining from the lump-sum option becomes available as an inheritance.

There is rarely a clear cut answer with pension versus lump-sum options. Providing a framework to deal with all of the uncertainties will help them make an informed decision. George and Olivia decided they should take the lump-sum because of health considerations and their ability to take on slightly more risk in their portfolio. Their children will benefit from any extra inheritance the lump-sum may provide.

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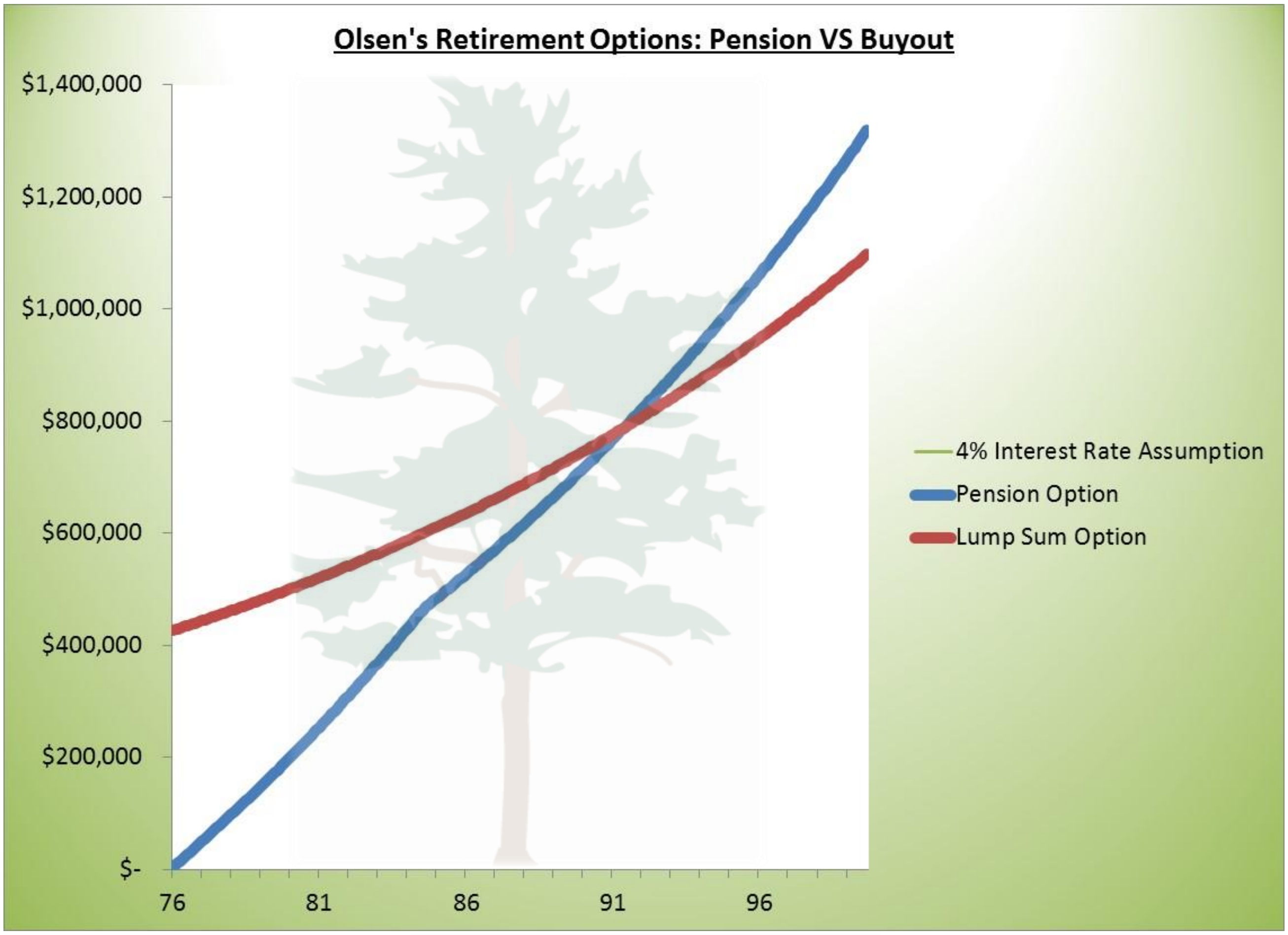

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