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YOUR PRACTICE-Helping clients choose annuities or lump sums

By Ed McCarthy (excerpt)
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Your client plans to retire soon and his employer's defined benefit plan offers a choice: take a monthly pension or a lump sum distribution that can be rolled over to an Individual Retirement Account. The client wants your input because a good chunk of his net worth is tied up in the plan, not to mention his retirement security. …

SEEING THE NUMBERS

…David Kudla, chief executive officer of Mainstay Capital Management LLC in Grand Blanc, Michigan, has worked on numerous pension-or-payout decisions. Many of his clients work for the auto companies, which have offered lump-sum buyouts to tens of thousands of employees in recent years.

For Kudla, the first round of the analysis is a math question. He knows the client's age and life expectancy (and his spouse's, if the client is married) from the IRS tables. The plan provides the pension payments and the available lump sum. Using those numbers, he can back out the discount rate - the internal rate of return - the plan sponsor is using in its calculations.

He then estimates the return the rolled-over lump sum could earn if he were managing it, based on typical historic returns of the various asset classes he would recommend. If the investment portfolio produces a higher value, then it makes financial sense to roll over the funds; otherwise, the pension can be a better choice. Armed with that result, Kudla and the client start to consider the qualitative factors in the decision. …

THE CASE FOR ROLLOVERS

…The monthly benefit check may be valued for its dependability, but it lacks flexibility. A check for the same amount shows up each month whether or not the client needs the cash - and those benefits typically are considered taxable income. When pension recipients die, the checks stop and their heirs get nothing. In contrast, lump sum distributions turned into rollover accounts allow investment choice, control over income- and tax-timing and more flexible estate planning.

Larger pension payments are also at risk for reduction if the plan goes bankrupt. Beginning in 2014, the Pension Benefit Guarantee Corporation's coverage limit for a 65-year-old retiree is $59,318 annually. Clients taking early retirement face lower age-adjusted limits and payments from supplemental executive retirement plans go on the chopping block, as well.

Kudla has encountered these limits with early retirees from Delphi Corp, which went bankrupt in 2005. "There were people that saw their pension payment get cut by a quarter ... (or) a third for the rest of their life," he says.

(over, please)

BEYOND THE NUMBERS

But it is not just about numbers. Clients' financial goals and risk tolerances vary, and some people find it easier to overlook the slow loss of buying power to inflation than to ignore the stock market's headline-grabbing gyrations.

Both Frank and Kudla say their role as fiduciaries requires them to accommodate clients' preferences, even when they believe a rollover is the better option. Consequently, they'll make their case but will refrain from trying to sell the client on taking the payout.

Kudla's experience with General Motors' buyout offer in 2012 provided a good example of how client feelings play into the whole calculation. Only 27 percent of his clients there took the lump sum; the rest chose to receive a monthly payment.

But their reasons had little to do with the calculations Kudla prefers, and more to do with psychology: During their careers they had planned on receiving a monthly pension and that was their mindset. …