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The value of a pension

by Steven Podnos Md, Cfp • Nov. 10, 2015 • 1 min read • original

Many individuals are employed in occupations that come with a pension in retirement. Here, I define pension as an income for life, usually based on years of work and salary. For example, most government jobs come with military or civil service pensions.

Pensions can differ in a number of ways—for example, some can adjust for inflation. Most pensions have the choices of different joint and survivor options. This means that if the primary worker dies, his or her spouse receives some percentage of the pension over their remaining lifetimes (usually 50% or 75%.) These joint and survivor choices reduce the primary pension payout in proportion to the extra cost of insuring the surviving spouse.

There are three ways to consider the value of a pension.

The value of cash flow

The first is to consider the value of the cash flow. Take, for example, a retired executive with a pension of $80,000 a year. It may be that this amount, along with Social Security, allows the executive and his or her spouse to meet their lifestyle expenses. Having money in a retirement portfolio is just icing on the cake. Whether the pension is inflation-adjusted becomes important in this assessment, as decades of inflation might markedly reduce its worth.

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The value of the portfolio

A second way to value a pension is to consider what you would need to have in a retirement portfolio in order to generate the pension income.

For example, you might say that at a 4% distribution rate, a $40,000 annual pension would require a portfolio of $1 million. This is acceptable for valuing the pension for the retirees, but the portfolio assets are potentially worth more than this because they may remain after death, whereas pensions stop. In addition, most portfolio distribution plans include adjustments for inflation, but a pension may not.

The value of comparison

The final and perhaps most accurate way to value a pension is to compare what it would cost to buy an immediate annuity that would pay the same income starting at the same age. Take the retired couple with the $80,000 annual pension mentioned above. To receive the same joint lifetime guaranteed income from an insurance company would cost just over $1.5 million.

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The value of a pension: Three considerations

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One important variable to consider is the safety of the pension. Many corporate, and some municipal payers of pensions have defaulted on their promises due to financial distress (see the recent case of Detroit). A promise to pay an income for decades is serious business. I'd consider only the U.S. government itself as a totally safe source of pension income (military and U.S. civil service pensions), because it can always print the money with which to pay you.

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