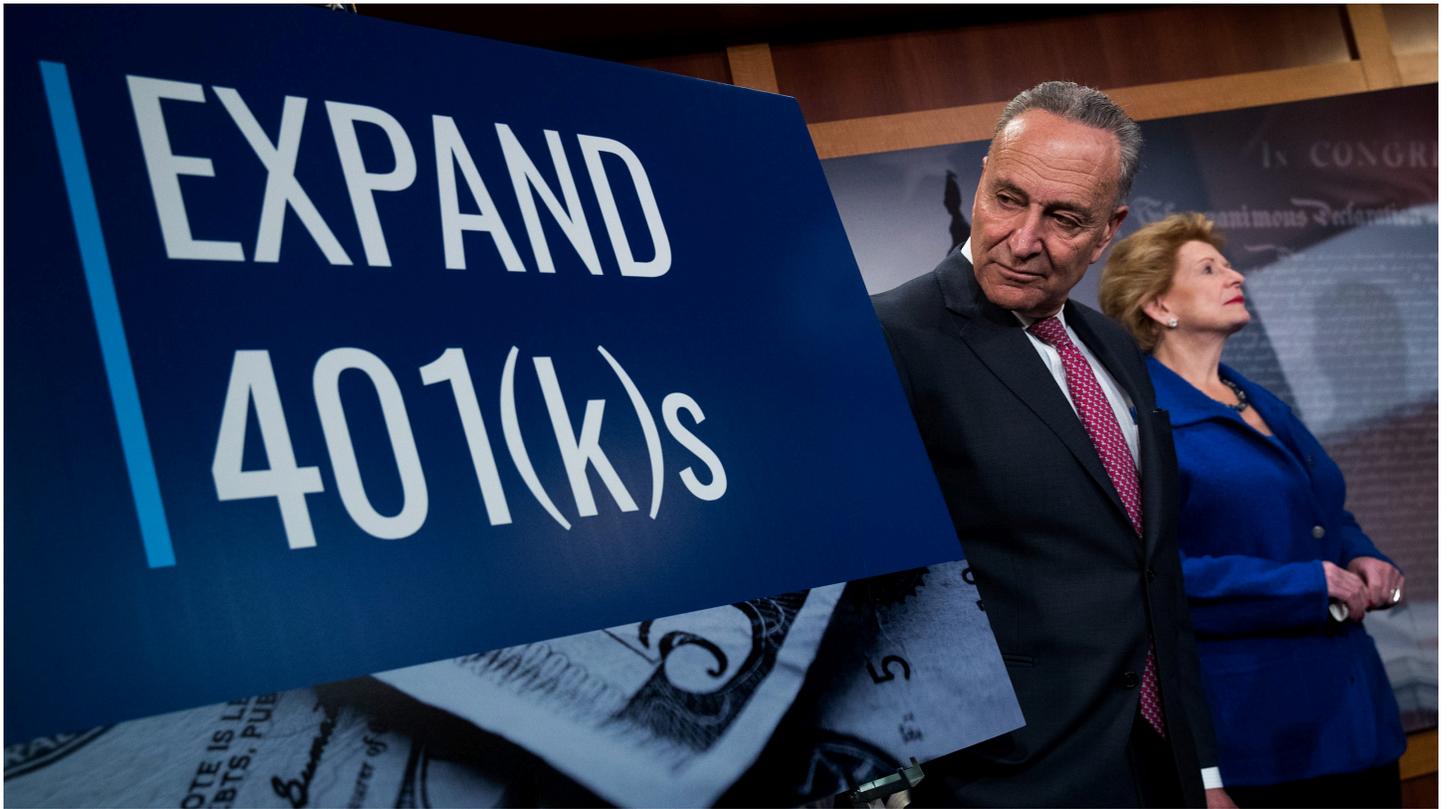


## How do I decide on taking my pension as a lump or as an income stream?



NEWS

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For FLORIDA TODAY

Feb. 6, 2026, 5:00 a.m. ET



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- Deciding between a pension lump sum and an income stream involves calculating the "present value" of future payments.
- Factors like your health, life expectancy, and the impact of inflation on future payments should be considered.
- You must also evaluate your own investment discipline and whether you could earn more by investing the lump sum yourself.

Q: How do I decide between taking my pension as a lump sum instead of an income stream?

A: It is common to confront decisions on accepting an income stream rather than a lump sum at various stages of life. [Two of the most common times for this are the decision on seller financing a mortgage when you sell a house \(or if you invest in mortgage notes\) and whether to take a pension as hard cash instead of a stream of income.](#)



The decision process involves trying to determine the "present value" of the income stream. If the present value taking long term income is greater than the lump sum, then it looks attractive, and vice versa. Note that the present value of an income stream that is tied to a life expectancy (as opposed to a mortgage which is usually a fixed term) and is therefore hard to determine. We don't know how long someone will live and we

don't know what the fixed income stream will buy far out in the future (due to inflation). But we can make decisions based on a few factors.

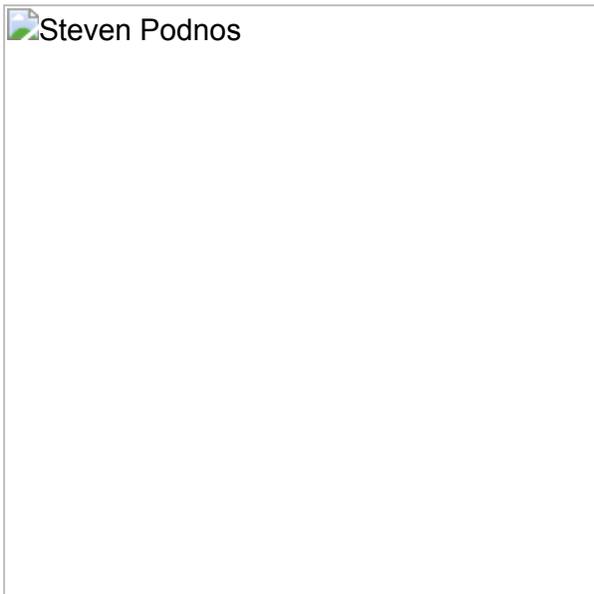
First, if one's life expectancy is not expected to be normal or longer (you have a chronic illness, etc.) then the lump sum is probably preferable. After that decision, let's think about other variables and review the decision on a known period for the income stream (not necessarily your life expectancy).

## **\$500K now or \$800K over the next 20 years?**

We'll assume that you are approaching retirement and have been offered a lump sum of \$500,000 or a payment of \$40,000 a year for life, but for not less than 20 years (benefits if you die before 20 years have elapsed go to your heirs). In essence, you must decide between \$500K now or \$800K over the next 20 years. How do you decide?

First, what will be the effect of inflation on the purchasing power of your future dollars? If long-term inflation continues at the 3% (the average rate of the last 50 years), your last few payments will buy barely more than one half of what they would today. Figuring out the present value is the process of trying to calculate how future payments are different than today's dollars.

Next, you must consider your alternatives. If the income stream has an internal rate of return of say 3% (a good advisor can help with this calculation), then you might think you can do better investing the lump sum elsewhere. This of course depends on your ability to choose and maintain disciplined and diversified investments with a safe withdrawal rate. But if you are not disciplined in the way you spend, an income stream rather than a lump sum might be safer.



A final consideration is the credit stability and even solvency of the payor. Unless it is the U.S. government, any other payor may not be around to pay you as promised. This is an important factor in an age in which multiple huge corporations have reneged on promised payments (think Delta Airlines, American Airlines,

General Motors, etc). Even insurance companies get into financial trouble — in 2008, several had to be bailed out. Municipalities like Detroit have also been unable to fulfill their pension obligations.

All these things need to be considered in your decision-making process. I don't think it is ever clearcut. In most cases, seeking out an advisor who puts your interests first is worthwhile.

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