Pension vs Lump Sum

> A monthly pension and a one-time lump sum are hard to compare until you put them in the same units. Present value is how you do it.

At retirement many people are handed a choice. Take a pension that pays a set amount every month for life, or take a single large lump sum today. They look nothing alike, which is exactly why the decision feels hard. The trick is translating both into the same measure.

Put both in the same units

A lump sum is a value today. A pension is a stream of future payments. To compare them, you convert the pension into its present value, which is what all those future checks are worth in today's dollars once you account for the fact that money now is worth more than money later.

The tool for that is a discount rate. A higher rate assumes you could earn more on a lump sum, which lowers the pension's present value and favors taking the cash. A lower rate favors the pension. The rate you pick is the single most important assumption in the whole decision.

A worked example you can reproduce

Suppose the pension pays 2,000 dollars a month for 25 years, and the alternative is a 350,000 dollar lump sum. Discounting those payments at 5 percent gives the pension a present value of about 342,000 dollars.

On those numbers the lump sum is slightly ahead, about 8,000 dollars, so a pure value comparison narrowly favors the cash. But change the discount rate or live longer than 25 years and the pension can pull ahead. The Pension vs Lump Sum Calculator computes this and also solves the break-even discount rate where the two are exactly equal.

The risks each side carries

The pension trades away control for security. You cannot outlive it, and you do not have to manage it, but you also cannot leave the balance to heirs, most pensions do not rise with inflation, and if the payer runs into trouble the promise is only as strong as its backing.

The lump sum trades security for control. You can invest it, leave what is left to family, and adjust withdrawals, but you also carry the risk of poor returns, overspending, or simply living longer than the money lasts. Neither is safer in the abstract. It depends on your other income, your health, and how comfortable you are managing a large sum.

Key takeaway. Convert the pension to present value so both options are in today's dollars, then weigh guaranteed income against control. The discount rate and your longevity decide it.

Assumptions

- The pension is a fixed monthly amount for life. Present value discounts those future payments at a rate you choose.
- The discount rate and your life expectancy are estimates, and they move the answer a lot.

Sources

- U.S. Department of Labor, pension and lump-sum decisions
- Consumer Financial Protection Bureau, pension lump-sum payouts