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Stern Advice: Are GM-like pension offers a good deal?

By Linda Stern
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WASHINGTON (Reuters) - Over the next few weeks some 42,000 white-collar General Motors retirees will take a crash course in actuarial math.

The company is ending their pension plan, forcing a decision on whether to take a lump sum or accept a private group annuity from Prudential that would replace GM's monthly pension benefits dollar for dollar.

With that, they are facing the same question that retirees and near-retirees encounter every day: Do I want an annuity?

There are a few special wrinkles to the GM plan, and talk that other companies could follow this precedent; the market for pension transfers from employers to insurance companies could increase in the next few years.

Worker advocates don't like it.

"We would not want to see this become a routine practice," said Nancy Hwa of the Pension Rights Center, a Washington advocacy group. "The retirement security of GM retirees will suffer."

On the other hand, those retirees now get a second chance to decide how they want to take their retirement benefits. Here are some questions they - and anyone weighing a lump sum buyout or a private annuity - should ask:

-- What number do I have to beat? There is an interest rate at the heart of the lump sum calculation determined by Internal Revenue Service's rules and tables. GM is not saying what interest rate it is using. Company spokesman Dave Roman says that the average rate among all the offers would depend on how many retirees take their lumps and whether there is a pattern to those who do.

But last year, GM used 4.15 percent when it calculated the current value of its pension for its public accounting statements. Right now, the range of rates supported by IRS tables is roughly 3.5 percent to 5 percent, says David Kudla, a Grand Blanc, Michigan, financial adviser with many GM retirees as clients.

In a hypothetical calculation based on average life expectancy (these are not GM figures), a 65-year-old retiree receiving $40,000 a year may be offered a lump sum of $430,000 if the rate was 5 percent, and $485,000 if the discount rate was 3.5 percent, Kudla calculated.

"That is not a significant hurdle to surpass," Kudla says. He - and most likely many private money managers - believe they can get better returns than that for their clients.

-- What would be my monthly take? Now and later? Of course, if a private financial adviser took $485,000 and invested it for the long haul, it's unlikely he would let a client pull $40,000 out the first year. For long-term safety, a starting withdrawal rate of 4 percent or 4.5 percent is a general rule of thumb, meaning that someone who decided to take the lump sum probably should not withdraw more than about $22,000 the first year.

But private investments grow, while most pension payments, including GM's, do not. In 25 years, someone who chose the annuity would still be getting $3,333 a month, but at 3 percent annual inflation, it would buy about as much as $1,592 does now. Someone who invested the $485,000, earned an average of 8 percent annually, and pulled 4 percent out a year, would be drawing roughly $4,300 a month in 25 years and still have $1,292,941 left (according to the savings withdrawal calculator at Bankrate.com).

In the current investment environment, is that 8 percent projected return too optimistic? In the 10 years that ended on May 31, 2012, a portfolio of 50 percent stocks and 50 percent bonds, rebalanced annually, would have returned 7.88 percent, according to Morningstar. The very long-term history says that 50/50 portfolio returned 8.38 percent a year between 1926 and May 31, 2012.

-- What if I die on Tuesday - or not until I'm 115 years old? Retirees who go for the lump sum will have to be conservative about their withdrawals if they want that money to last a lifetime. On the other hand, they will be able to pass the remainder to their heirs. With the GM deal and most annuities, only spouses can keep the pension tap on, and only if spousal benefits are elected.

-- Who is backing these payments? Consumer advocates like Hwa and Woodstock, Georgia, financial adviser David Hultstrom are not comfortable trusting their retirement streams to a single company. "You wouldn't put your entire retirement account into one Prudential bond would you?" Hultstrom asked.

To be sure, Prudential has never defaulted - or even been late - on an annuity payment in almost 85 years of doing these kinds of deals, says Senior Vice President Dylan Tyson. He says the money for these pensions is safely tucked away, but if some grievous event took Prudential down, GM pensioners would have to turn to their individual states for annuity coverage. In Michigan, the maximum annuity contract that the state will guarantee is $250,000. (To see every state's annuity guarantee limits, check the chart here .)"We would definitely trust the Pension Benefit Guaranty Corporation more," Hwa says.

-- What about taxes? Taking the lump sum offers retirees more opportunities for tax management, because the money would reside in a tax-deferred IRA. Assuming they had other investments and funds to live on, they could withdraw more money during low-tax-bracket years, and less money during more taxing years. After age 70 1/2, they would have to take mandatory minimum distributions.

-- Can I hedge my bets? The GM deal does offer retirees one opportunity. If they want to have their cake and eat it, they can take the lump sum and, with a piece of it, buy a fixed annuity privately. It may be difficult to buy a single annuity that pays out better than the institutional-sized one that GM presumably negotiated, but checking with inexpensive providers such as Vanguard (www.vanguard.com) or comparison sites like AnnuityNet.com or AnnuityScout.com could turn something up.

That would keep some money coming in forever, taking care of the longevity risk. Yet it would leave some money to diversify, use in spurts, or bequeath to their grandchildren. They could also tend to their own investments for a few years and buy an annuity later, when, presumably, higher interest rates and their own advancing age would offer a better payout.

Finally, Hultstrom suggests one other way for pensioners to "hedge." He suggests that retirees who can afford it get a new 15- or 20-year home mortgage. With 15-year loans now averaging 3.06 percent in (usually tax deductible) interest, the retiree could invest that money, and hope to beat the rate they are paying on the loan. That would give them the growth they will not get from the annuity, he says.

Of course, they would have to be able to make their monthly payments - and live with the risks of betting the house on their investments - but those are questions for another day.