



# Behavioural Finance and Commuted Values

Patrick Longhurst

I was only recently introduced to the concept of behavioural finance and do not, by any means, pretend to be an expert. My understanding is that it refers to the dichotomy that exists between the sophisticated financial markets and the personal foibles of folks like you and me. For example, if I seriously believe that I should never sell an investment unless it is trading for at least what I paid for it, this is going to have a significant impact on my investment performance, regardless of the quality of advice I may be receiving.

This got me thinking about the whole issue of lump sums versus streams of income, which is a fundamental element of many of the pension decisions we have to make, whether they relate to:

- taking a commuted (lump sum) value or a pension;
- purchasing past service in a defined benefit pension plan;
- buying an annuity with registered or non-registered funds.

Does behavioural finance play a part in these decisions?

To start with a simple example, suppose you have won a lottery which entitles you to \$1,000 per month for the next 20 years, guaranteed. What lump sum would you require in order to give up your prize? A pragmatic answer might be to multiply the \$1,000 by 240 months and ask for \$240,000. A financial planner would ask some questions about:

- The tax treatment of the annual payments and of the lump sum;
- The after-tax rate of return that could be earned on the lump sum;
- Any other impacts on government income programs etc. and would calculate a lump sum present value, which would likely be less than \$240,000 (say \$180,000 allowing for an after-tax rate of return of 3% per year). But I firmly believe that there are people who could be persuaded to take \$100,000 on the premise that “a bird in the hand is worth two in the bush.” These people are not dummies; they simply do not understand the concept of present values. Or maybe they have some pressing bills!

Suppose we make the question more challenging. The

prize is now \$1,000 per month for life and payments will be increased annually at 3% per year. What lump sum would you require to give it up? The pragmatist will have a greater challenge in coming up with an answer. The financial planner will ask about life expectancy and will come up with something (probably \$300,000 with a life expectancy of 25 years). The potential for someone taking too little has been increased again.

Now consider the real world of defined benefit pension plans. Typically the pensions are payable not just for the life of the member, but also in a reduced form for the lifetime of the surviving spouse. Indexing of the pension in line with the consumer price index may or may not be guaranteed. The pension is fully taxable. What commuted value would you want to give up this pension? Once again, the financial planner can probably come up with a value, but the calculation is complicated. A critical issue is that the commuted value will be partially eligible for a rollover into a Locked-in Retirement Account (LIRA) and partially payable as a taxable lump sum. How can the person who had difficulty with the initial 20-year lottery win, sort this one out? The answer is that they frequently cannot, and that they take the commuted value because it seems like a lot of money at the time.

What is the solution to this situation, which may affect the largest asset that an individual will amass during their lifetime? The answer has to be financial education. But who is willing to provide it? Ideally, we should all learn this type of thing at high school, but it isn't happening. There are always financial planning classes available, but the curriculum does not always cover this type of issue. If the plan sponsor is to do it, then it will be a departure from the current practice of describing the plan terms but not looking at the decision-making process. Maybe it is up to magazines like *MoneySaver* to provide an objective thought process and to have it always available on their website, for when it is needed.

## Revisiting the Canada Pension Plan

As readers of this column will know, changes to the Canada Pension Plan are expected to become effective on January 1, 2011. One change relates to participants who start their CPP benefits before age 65. After January 1, 2012, if they still have eligible income, they will not only be receiving a pension, but also actively participating in the Plan and earning incremental increases to their benefits each year. This ongoing participation will be mandatory until age 65 and voluntary from 65 to 70. The change applies to both the employed and the self-employed. At the time I wrote my original article for *MoneySaver*, I commented that “these changes will not affect anyone who is already receiving a CPP retirement benefit on January 1, 2011.” However, this is not quite true, as the following example will illustrate.

Suppose Mr. X was born on January 1, 1950. On January 1, 2010 he retired from his job at age 60 and applied for a reduced CPP benefit. However, on January 1, 2011 he decided to start working part-time and is making \$20,000 per year. Effective January 1, 2012, he and his employer will be required to contribute on his behalf to the CPP. Each year, starting January 1, 2013, he will receive an incremental amount of pension because of these extra contributions. If he is still working on January 1, 2015, then he can decide whether or not he wants to continue to contribute. Some people are upset about this change. However, for people in this position, it is probably money well spent. It may be harder for the self-employed to be philosophical about this change, as they will be asked to pay both the employee and employer share.

## U.K. Social Security

Many of you will be pleased to hear that this is my last instalment of “Patrick’s adventures with HM Revenue & Customs”! I have now purchased all of my eligible past service under the National Insurance Scheme. In fact, I am now being billed current service for the period from July 11, 2010 to October 9, 2010. My purpose in writing this series was to alert any reader who has lived or worked in another country to the fact that they may be entitled to some benefits under the social security arrangements. As a client of mine says, “One advantage of getting older is that you no longer mind asking silly questions!”

Please keep your comments and questions coming.

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