

“Capitalization” of pensions and Social Security

The value of pensions, Social Security, and other long-term, reliable sources of income can be considered fixed-income investments, for purposes of asset allocations.

Assume you are an investor, 70 years old, who has pension income of \$50,000 per year, and Social Security of \$20,000 per year.

If you could, what would you sell that income stream for? Enough to provide you with an income stream of \$70,000 per year for the rest of your life (assumed to be 20 years?)

Assume you could buy a AAA rated, mortgage backed security, 4% yield, amortized over 20 years. To generate an income stream of \$70,000 per year for 20 years, you would need to buy a security of \$951,322. At 5%, a security of \$872,354.

In the 4% example above, the “cap rate” is 0.07366, or 7.366%. $\$70,000 / \$951,322$

In the 5% example above, the “cap rate is 0.08024, or 8.024%. $\$70,000 / \$872,354$

If your pension, Social Security are \$100,000, then it is worth \$1,357,589 capitalized at 7.366%, or \$1,246,261 capitalized at 8.024%.

Cap rates change. Impacted by:

Interest rates

Risk (credit risk, volatility, inflation)

Risk/opportunity for capital gains or losses from the investment

Higher cap rates = lower capitalized value.

Real Estate is valued by cap rates. NOI / selling price.

Assume: you have a \$2 million investment portfolio, and \$70,000 in pension and Social Security. You want to be allocated 50/50 equities/fixed income.

Capitalizing your pension and Social Security at \$900,000 (approximately) then your total wealth (including capitalized pension and Social Security) is \$2.9 million. With 50/50 asset allocation, you would allocate your investments: \$1,450,000 to equities, and \$550,000 to fixed income, with the \$900,000 capitalized value of your pension and Social Security counted as a fixed-income investment.

Takeaway: .07 to .09 (7% to 9%) is an appropriate “cap rate” for pensions and Social Security income, at today's interest rates. Considering pensions and Social Security as fixed income investments, allows most investors to allocate a greater portion of their investment portfolio to equities or riskier assets.

