

MAKING SENSE OF THE
LUMP SUM PENSION CALCULATIONS
Part One

When you leave Idearc, you'll be taking with you many Benefits you've earned during your years at Verizon/Bell Atlantic/Nynex/New England Telephone. The largest one may well be your **Pension**.

If you have been with the company a long time, you'll have earned your Pension Benefit under Highest Average Pay formula. And, you'll be asked to choose between taking an annuity and a lump sum.

This decision is all about the investment markets. It's also about your tolerance for Risk, but that is also about how Investing works, and how well you do at it.

How do you decide?

First, it's helpful to understand how the calculations equate your two choices: A lifetime monthly annuity vs. a single lump sum. You'll best understand this as a **Mortgage in Reverse**. Here is the comparison.

The Company owes you a monthly payment for the rest of your life. This is just like you owed the bank a monthly payment for the life of your mortgage loan. So, what determined the payment? Three things; the Principal you borrowed, the term of the loan (like 30 years) and the interest rates at the time. If the monthly payment was fixed, say, at some portion of your income, then the amount you could borrow (and therefore afford to pay for your house) depended on the term of the loan, and the interest rates.

In this case, you are the bank. The Company owes you a fixed monthly annuity, and you have the option of taking it, or demanding that they pay off the entire balance. Just like the amount of principal you could borrow to purchase your home depended on the term of the loan and the interest rates, the lump sum they will give you depends on how long you will live, and similar interest rates. So, logic would tell you, the longer you live, the higher the lump sum. Not so clear; the lower the interest rates, the higher the lump. But think back and you'll remember, when rates were low, you could afford a bigger house, right? So, low interest rates equated to a bigger mortgage balance, and now, they equate to a bigger lump sum.

Well, you can't do much about your life expectancy! You'd think you could live healthy and live longer, and that may well be true. But, in the Pension Calculation, everyone is created equal. You'll get a life expectancy that's equal to the average lifetime of everyone in the Plan. For any given age when you retire, the number of years you've got left is set down in a table. You can live longer, but you can't convince them to give you more money in your lump sum because of it.

So, that just leaves the Interest Rates. What are they, and which way are they going? Here is a little table with an example. It applies to a monthly annuity of \$3870.

<u>Interest Rate Type</u>	<u>Lump Sum</u>	<u>Interest Rate</u>	<u>Mortality</u>
10-yr. Treasury	\$616,920	4.00%	Plan Mortality
GATT	\$653,990	4.37%	GATT Mortality
PBGC	\$642,265	3.60%	Plan Mortality
Quarterly GATT	\$594,160	5.31%	GATT Mortality

So, what can we learn from the table. Well, first of all, the GATT rate of 4.37% with GATT Mortality achieves the largest lump sum. Fortunately, the Pension Plan is required to give you that best result. But, why doesn't the PBGC rate of 3.60% create the biggest number? It's because the Plan Mortality is less than the GATT Mortality, and the PBGC rate uses the shorter of the two. Mortality refers to a number in the table where your remaining life expectancy is stated. Remember, if you are expected to live less, they will expect to pay you less.

Now, we can actually do the math for this and figure out what that Mortality is: Its 22 years! We know this because we know what the monthly payment is, and what the interest rate is, so we can use a Mortgage Calculator to figure the term of this "loan" is, and it's very close to 22 years.

We can also figure out how much the Lump Sum would change, if the interest rate (GATT) went up by 1%. It would drop to about \$597,215. So, just like a sudden rise in interest rates would put a damper on your plans to purchase a home, changing interest rates have a big effect on your lump sum. They do not, however, have any effect on your monthly annuity, as long as that is calculated using the Highest Average Pay formula.

Next month, we will have a continuation of this discussion, focusing more on what these important interest rates really are, and how they are affected by the Investment Markets. Here is a hint: they are not set by the Federal Reserve Bank, although they may be influenced by what the FRB is doing. For the most part, they move according to the same kind of forces that push the Dow Jones up and down; supply, demand, fear and greed. More about that next time!

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