STRUCTURED Settlements from an Investor's Perspective

BY LAURA MULLIN

Understanding the value of a structured settlement

Most personal injury lawyers are well aware of the traditional benefits of structured settlements. For vulnerable clients, there is no better guarantee of payment than a periodic, tax-free structured settlement. Every personal injury lawyer has represented clients who simply NEED the protection a structured settlement affords – to avoid misspending the settlement funds, or being too easily parted from these funds by less than trustworthy "friends".

In cases where Court approval is required for a significant settlement, structuring some portion of the settlement has become a "must" in many jurisdictions.

In cases where competent adults are involved, however, structured settlements seem to have developed a reputation in recent years, of being a "low return" option.

Comments abound about "low structure rates" and the prospect of "doing better elsewhere". Presumably that "elsewhere" is in a well-managed, balanced traditional investment portfolio. Invariably, we hear financial advisors assuring plaintiffs that other investments are a better option than a structured settlement at current rates.

Is that really true? Is there truly a "better" investment out there?

In truth, there is no other guaranteed investment that can match the current[1] rate of return in a structured settlement.

When the impact of taxes and investment fees are considered, even a well-managed balanced portfolio that strives to minimize (it cannot eliminate) investment risk, must achieve above-average projected performance year after year (not just sometimes) just to match the current return on a structured settlement.

Structured Settlements versus Other Guaranteed Investments

Currently, there is no investment available in the market that can **guarantee** a better rate of return than structured settlements. When looked at for their pure investment value, structured settlements offer guaranteed, tax-free yields that would make any non-injured investor wish he or she could have one.

Comparing structured settlements to non-guaranteed, taxable investments is like comparing apples to oranges.

Consider the following:

- A 10-year structured settlement paying annual interest only (like a bond) currently provides a guaranteed, tax-free return that is over 92% higher than a 10-year Government of Canada Bond.[2]
- A 20-year structured settlement currently provides a return that is over 31% higher than a long-term Government of Canada Bond.[3]
- Some of the major banks are currently offering 10-year GICs promising (taxable) returns of 2% to 2.1%. A structured settlement with a similar format (a single payout at the end of the term) currently provides a tax-free return of 3.33%.

Think about what that last example equates to in a taxable investment.

At a 20% marginal tax-rate, this structured settlement is akin to your bank offering a guaranteed GIC rate of 4.16% today. At a 30% tax-rate, it is the equivalent of a 4.76% GIC, and at the current highest marginal rate of over 49%, this equates to a GIC rate of over 6.5%.

When the impact of tax is considered, the structured settlement suddenly looks much more attractive.

But what about other investments, such as a well-managed, balanced portfolio that promise better overall returns than current structured settlement yields?

Structured Settlements versus "Balanced" Investment Portfolios

If guaranteed investments cannot match the return from a structured settlement, can a diversified investment portfolio put in place by a good financial advisor?

Perhaps…but your client has to be comfortable with investment risk. That is, he or she needs to be comfortable with the uncertainty of placing at least a portion of his or her settlement money in investments that come with no guarantees, and might even result in negative returns (losses).

He or she must pay tax on the returns (if positive), as well as annual investment management fees. Both payments erode the true return on the investment.

In comparing structured settlements to other investments, the projections for the alternatives often look great on paper. These future projections are frequently based on past averages (which are certainly no guarantee of future performance), without clear estimates of the impact of taxes and fees, and usually no detailed discussion of the risk involved in the alternatives.

Some plaintiffs are saying "no" to structured settlements without truly understanding the favourable rates of return they offer. This is usually because the impact of tax and investment fees are not considered when alternatives are considered.

In his article *Wake Up Canadians – You Need to Start Asking More About Investment Fees*,[4] Rob Carrick discusses a mystery shopping exercise undertaken by Canadian securities regulators which discovered that, of the 88 test interactions undertaken, the fees were discussed only 56 per cent of the time, and compensation for the advisors was discussed only 25 per cent of the time.

The intention here is not to pick on financial advisors but, rather, to encourage comparisons of structured settlements to alternative investments on a true "net return" basis.

Comparing structured settlements to non-guaranteed, taxable investments is like comparing apples to oranges. In order to make accurate comparisons, three simple questions should always be asked:

- What is the impact of taxes?
- What is the impact of fees?
- What is the risk associated with the alternative?

Take, for example, the alternative "balanced" investment proposal that illustrates a prospective return (based on past averages, but not guaranteed) of 6% annual growth into the future. This is a common projection from financial advisors for future returns in balanced portfolios. Assuming (and it **is** just an assumption) this 6% return is actually achieved, what does that produce for the client, after management fees and taxes?

At a 20% overall tax rate, and assuming a 2% plus HST management expense fee,[5] this equates to a net return of 2.99% overall. This is **less** than the current tax-free, no-fee return provided by a 20-year structured settlement.

At a higher tax rate, or with higher investment fees, the differential in favour of the structured settlement becomes even greater.

In addition, the 6% projection assumes that your client does not fall victim to "bad market timing". If the investment performs poorly at the outset, the returns it must generate in later years, just to match the structured settlement, grow exponentially.

This is compounded by the fact that most clients must draw money from their investments every year to meet ongoing needs. If the investment performs poorly in the first years, most clients cannot "wait out" the downturn. Instead they are obliged to keep withdrawing amounts during those years to pay ongoing expenses. The result is that that the subsequent returns in the investment portfolio must be higher still.

The Danger of Waiting for Rates to Improve

Sometimes, there is reluctance to structure because of the fear of "locking-in" now, in case rates improve in the future. There is no guarantee if, or when, this will occur and the longer the wait, the larger the return required just to match what the client has lost in the meantime.

To say "no" to a 3% tax-free, no-fee return today in the hopes that rates will improve "soon", means that the client must find a place to put the money while waiting for the improvement. If the alternative is a safe place (a GIC, for example), the return will be lower than that from the structure, and it will be further eroded by the impact of taxation.

The investor must then hope that rates improve enough to overcome that lower return, and to overcome the tax hit that comes with the alternative investment. Depending how long it takes for interest rates to improve, the plaintiff may never make up for what was lost by not structuring in the first place.

The Investment Reality – Plaintiffs are "Retirees"

Favourable structure rates aside, the reality for most personal injury plaintiffs is that generating investment income is actually a secondary concern. The first priority is addressing their day-to-day needs.

Most plaintiffs, regardless of age, have the same investment needs as retirees. Like a retiree, they look to a future with no or limited employment income, yet day-to-day expenses continue. Like any retiree, the primary concern for most plaintiffs is ensuring that enough reliable, regular income flows into the household, so that the bills can get paid.

Think about what your investment goals might be when you retire. Likely, you will be seeking a guaranteed stream of income that will last for as long as you do. At that point (like the average plaintiff), you will no longer be bringing in a paycheque, yet your bills must still be paid and likely, your tolerance for investment risk will be much lower than it is right now.

At retirement, if you could take at least SOME of your savings and purchase a guaranteed, tax-free defined-benefit pension with a return possibly double what a government bond is paying, would you be interested?

Don't dismiss the investment value of a structured settlement. It is your client's one chance to build a guaranteed, tax-free "paycheque" with a rate of return that cannot be matched without considerable investment risk.

A diversified portfolio has a significant percentage of fixed income investments and equities. At the very least, the plaintiff proceeding with such a portfolio should structure the portion earmarked for the fixed income investments. The structure would provide a better return and if the equities truly do perform as expected, the plaintiff would then have an even better overall return.

Get the right to structure. Have your client speak to a structured settlement specialist and make a fully-informed decision. That way, you will know your client has had every opportunity to consider all of the options available for his or her settlement funds. This protects you as well.

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NOTES

[1] All values referred to in this article are based on rates as of November 26, 2015. Values are, of course, subject to fluctuation over time.

[2] The 10-year (taxable) Government of Canada Bond rate is currently 1.59% (taxable), while an identical structured settlement payout provides a guaranteed tax-free return of 3.06%.

[3] The current long-term Government of Canada Bond rate is 2.29% (taxable), while a 20-year structured settlement payout provides a tax-free return of 3.01%.

[4] Globe and Mail, published September 20, 2015

[5] According to the Investment Funds Institute of Canada *2015 Update Monitoring Trends in Mutual Fund Cost of Ownership an Expense Rations,* "average total cost of ownership of mutual funds for clients using advice-based distribution channels in Canada was 2.2% at the end of 2014".

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