Is Structured Settlement Annuity Investing A Good Deal? Yes, but...

As interest rates remain low, investors - especially retirees - struggle to find yield wherever they can. Unfortunately, though, the necessity of earning a required return to fund financial goals becomes the mother of invention for a wide range of investment strategies, both legitimate and fraudulent. A recent offering of rising popularity is structured settlement annuity investing, often offering "no risk" rates of return in the 4% to 7% range. In general, the opportunity for "high yield" (at least relative to today's interest rates) and "no risk" is a red flag warning. But the reality is that with structured settlement annuity investing, the higher returns are legitimately low risk; the appealing return relative to other low-risk fixed income investments is not due to increased risk, but instead due to very poor liquidity. Which means such investment offerings can potentially be a way to generate higher returns, not through a risk premium, but a liquidity premium. But the caveat, however, is that the investments are so illiquid and the cash flows so irregular, they probably should at best only ever be considered for a very small portion of a client's portfolio anyway.

The inspiration for today's blog post has been a series of inquiries I've received from other planners over the past month, whose clients are being solicited to invest in structured settlement annuities, but have been understandably wary of the purported "high fixed return with low risk" offering. After all, most returns that seem "too good to be true" for their risk are in fact too good to be true, and entail higher risk than what is first apparent. Yet due to the unique way that structured settlement annuities work, the reality is that higher yields are not actually a high risk premium, but a low-risk *low liquidity* premium.

To understand why, it may be helpful to review exactly what a structured settlement is. A structured settlement arises most commonly when a plaintiff wins a lawsuit - for instance, due to injury as a result of medical malpractice - and the payment for damages is awarded as a series of payments over a period of time. This is often done to coincide with certain key ages - for instance, the structured settlement for an injured child might be timed to have the bulk of the payments made after the child turns 21, while the structured settlement of an injured 45-year-old adult might include annual payments for the next 20 years and then a lump sum at age 65. Each situation is unique. However, to avoid the financial risks involved by having the plaintiff waiting on the defendent to make payments over the span of many years or decades, the defendent (or the defendent's professional liability insurance company) often purchases an annuity from a quality insurance company to make the obligatory payments to the plaintiff, allowing the defendent to resolve his/her end of the settlement with a single lump sum payment.

So where does structured settlement investing come into play? The opportunity arises when the plaintiff who is receiving the structured settlement annuity payments finds a want or need for more liquidity. Or as the infamous J.G. Wentworth (a company that buys structured settlements) commercials put it, "If you have a structured settlement but **need cash now**, call J.G. Wentworth, 877-CASH-NOW"! So the individual receiving payments contacts the company to explore selling the structured settlement income stream.

In practice, though, most such companies that buy structured settlements do not keep them in their own investment portfolio; they then re-sell the structured settlement annuity payments to an investor, pocket a small slice or charge a markup as a commission, and seek out another structured settlement annuity to buy and repeat the process. Which means ultimately, the company needs to find both an ongoing stream of people who have structured settlement annuities to sell (not surprisingly, easier to find in these difficult economic times), and investors who are willing to buy the seller's unique annuity stream of payments.

So what does this look like from the investor's perspective? Because each structured settlement was arranged for the winning plaintiff's particular circumstances, no two structured settlement annuity investment options are the same. One might offer $2,000/month for the next 18 years; another might provide for a single lump sum payment of $200,000 in 10 years and another $100,000 5 years after that, with no intervening payments; another might provide for a series of $1,000/month payments for 10 years, then a $100,000 lump sum at the end of 10 years.

How does the return work with such irregular payments? From the investor's perspective, this is similar to buying an original issue discount bond that matures at par value. For instance, if the structured settlement provides $200,000 in 10 years and another $100,000 payment 5 years thereafter, then the lump sum required for the investor might be $170,884; if you do the math (it's a standard IRR/NPV calculation for any financial calculator or spreadsheet), "investing" $170,884 today for $200,000 received in 10 years and another $100,000 received in 15 years equates to a 5% internal rate of return. However, it's important to note that you *don't* receive any kind of ongoing 5%/year payments (unless that happens to be what the annuity offers); your 5% return is solely attributable to the fact that that's how much money would have grown for the future value the investor gets from the annuity payments to equal the lump sum the investor paid today to get them. So the return is legitimate, but it's not comparable at all to the ongoing cash flows from a 5% coupon bond.

So why are the returns as high as they are? It's not due to risk; as noted earlier, the annuity payments are generally backed by highly rated insurance companies that are anticipated to have virtually no risk of outright annuity payment default (after all, that's what the original structured settlement payment recipient was counting on for those payments in the first place, and the court wouldn't have approved it if the annuity provider wasn't sound!). And the payments are generally guaranteed and fixed to the dates that are assigned; unlike lifetime annuitization that planners may be more familiar with, the payments from structured settlements generally are *not* life contingent (i.e., the payments will continue, even if the original annuity dies). Instead, the returns are due to sheer illiquidity. After all, how many people out there really want to buy an arbitrary structured settlement payment of $200,000 in 10 years and another $100,000 to arrive 5 years later, with no intervening cash flows? The answer is, not many. Yet in many cases, the structured settlement recipient really needs the liquidity for some reason, and can't wait long. The end result: the structured settlement recipient becomes willing to give up a healthy discount rate to get that lump sum of cash now.

So where does this fit for the financial planning client? The internal rate of return on many structured settlement payments are pretty appealing in today's marketplace; rates of 4%+ are pretty common (although notably, that's not a huge spread relative to the yield on comparable *long term* bonds). But most clients are unlikely to find a structured settlement that actually provides cash flows that line up with exactly when the client may need them, and there are only so many to choose from at any given time (for instance, here's a sample rate sheet from one provider) - which means at best, this should only be done with a small enough portion of the portfolio that it won't create a liquidity problem for the client investor. Otherwise, the client could themselves become the seller, and be forced to go through the same discounting process - bearing in mind that the structured settlement broker needs a cut too, so if the "cost" to generate a 5% return is $170,884 in the earlier example, the seller is going to get something less than that amount. This means that a buyer who becomes a seller will likely experience a loss of their own, as they essentially absorb both sides of what is a very wide bid-ask spread. Which means to say the least, this is for "long-term money" only! And of course, basic due diligence on the broker arranging the structured settlement and affirming the rating on the underlying insurance company is important, as always.

It's worth noting as well that structured settlement annuity investing is not just something that clients are being solicited for. Some of the structured settlement brokers involved are now reaching out to work with financial advisors directly as well (as a way to get access to more investment dollars), and in some cases advisors can actually be compensated and share in the commissions for helping to arrange such investments (not unlike how registered representatives are paid for many forms of annuity investing). However, this requires the broker/dealer to review and approve the offering (so that the registered representative doesn't get in trouble for selling away). And in practice, it seems that broker/dealers themselves are mixed on these offerings. At least one company I know of doesn't want to allow their representatives to do structured settlement annuity business not because they're unsound or risky, but because the broker/dealer is afraid that if more investor dollars flow into this space, it will encourage structured settlement annuity firms to be more aggressive and potentially even predatory in trying to persuade structured settlement recipients to part with their guaranteed payments in exchange for quick and easy cash now (as typical structured settlement annuity recipients are unlikely to "do the math" on the internal rate of return being used to discount their payments!). On the other hand, part of the reason for the high returns in structured settlement annuity investing is because there are so few investors involved that the market is highly illiquid and inefficient; in theory, if there were multiple companies competing for a structured settlement recipient's payments, there would be more competition, resulting in a higher price that both delivers more money to the seller and provides lower ("more competitive"?) yields for the investor.

In the end, structured settlement annuity investing can only go so far. There are just only so many structured settlement annuitants receiving payments out there, although in recent years this "industry" has expanded to also buy the annuity payments from lottery winners, and even some annuity payments from individuals who simply bought a commercial immediate annuity product and now want to liquidate it. Nonetheless, there is clearly some capacity constraint in how much this particular investment strategy can grow. But for the time being, the yields would suggest that the seller demand exceeds the buyer interest, which creates an opportunity for the client investor who can tolerate the illiquidity and has otherwise done the due diligence.

So what do you think? Have your clients been approached regarding structured settlement annuity investing? Did you counsel them to invest, or not? Have you considered getting involved with the brokers that offer such investments? Would you consider it to be a good right for the right client situation?

(Editor's Note: This post was included in SenseToSave's Carnival of Personal Finance #352.)