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Structured Settlements Meet Modern Portfolio Theory

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I have long been convinced that variable immediate annuities (VIAs) deserve consideration in financial deliberations at retirement. A recent conversation with Henry L. Strong, president of JMW Settlements in Washington, DC, convinced me that variable immediate annuities have another important use: financing structured settlements for clients who will be compensated for a physical personal injury claim.

These clients qualify for a unique income tax exclusion that few of them ever discover. Section 104 of the Internal Revenue Code enables claimants to secure a higher return via these nontaxable structured settlements than the after-tax return that they might otherwise generate by taking cash and investing it themselves. By agreeing to take a portion of their recovery over time, they can transform a one-time tax exclusion into a lifetime of tax-free income.

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The Impetus for Variable Annuities

Traditional structured settlements have been funded almost exclusively with fixed income investments—fixed annuities and government bonds.[1] A Private Letter Ruling from the Internal Revenue Service (IRS) places variable annuities squarely in the mix,[2] and at least one equity-based variable annuity has quietly entered the market to fill this need. Now asset allocation has become an important factor in the equation. Injured claimants can allocate as much as 50 percent of their structured settlement to an equity-based variable annuity sub-account and still not incur taxation on the payments generated from the annuity. In contrast, claimants who receive a lump-sum settlement must pay tax on the earnings from the funds.

Structured settlements take place in an unusual environment: the settlement of a physical injury claim or lawsuit. Timing is everything. To achieve the desired Section 104 tax exclusion, the terms of future payment must be written directly into the settlement agreement itself. Claimants cannot take actual receipt of the settlement funds and establish a structure themselves. They must remain insulated from actual ownership of the assets prior to the structuring, or the tax benefit is voided.[3]

Typically, the primary objective in these situations is not achievement of the optimal investment strategy for the claimant. Rather, it is resolution of the underlying claim. Only when that goal is achieved, or appears imminent, does the priority shift to what payment structure is best for the claimant. Meanwhile, emotional issues and immediate financial needs can complicate negotiations, making discussion of

the economic issues problematic. Complicating this fact is the dynamic of highly competitive lawyers aggressively defending their positions, perhaps at times losing sight of the ultimate goal.

Navigating through this tense, adversarial, often hostile environment is the role of structured settlement brokers, a fairly small group of annuity specialists who understand the economic advantage of the variable annuity approach. Penetrating the old order is difficult, though. The normal players—attorneys, claimspeople and judges—are accustomed to conventional methods that have proved successful in resolving claims in the past, and structuring the variable annuity is outside of their paradigm.

Why Modern Portfolio Theory Matters

Here's a reason that justifies counteracting this resistance. Ignoring the variable annuity option is tantamount to violating fiduciary responsibilities and the prudent investor rule. Further, it is in direct contravention of established investment principles and modern portfolio theory.

By continuing to fund multi-decade income streams with fixed annuity-only funding vehicles, negotiators unwittingly leave claimants defenseless against inflation.[4] Just because these plans are developed in the context of a claim settlement does not release them from the broader economic realities of investments. What's true for investment portfolios generally remains true for structured settlements: diversification is the key to achieving superior long-term results. Diversifying *by* asset class as well as *within* the asset class is critical for the claimant to preserve purchasing power over the long term in an inflationary environment.

A quick refresher on one of the building blocks of modern portfolio theory (MPT) perhaps is in order. Consider the risk-return graph shown in Figure 1. Recall that when two assets such as A and B are combined into a portfolio, the various return-risk combinations represented by all the possible percentage allocations between the two can be shown as a curve connecting the two points. How much the curve bows toward the vertical axis is a function of the correlation between the two assets. The lower the correlation, the more the curve bows, and the greater the benefit of diversification.

The point represented by A is the risk-return combination if the entire portfolio is invested in A. Notice what happens by adding a little bit of asset B to the portfolio that consists entirely of A. Moving up and to the left on the curve, the return increases and the risk decreases. In MPT parlance, asset A must be an inefficient portfolio. In fact, all points on the curve must be inefficient until the curve reaches its point of minimum risk—point C. Because point C has less risk and more return than all points between C and A, we say that C dominates them. There is no justification for holding those other portfolios. Moving along the curve from C toward B is a different case. Return is increasing, but so is risk. Different people with different risk preferences would prefer different points along the curve.

We can think of point A as being a fixed annuity and point B as being a variable annuity. Why isn't point A on the vertical axis—meaning no risk—if it is truly a fixed payment? Inflation must be considered. If we factor in inflation, the fixed annuity has considerable risk. Its effective real rate of return will vary every year with inflation, just like the variable annuity's return. Of course, the variability measured by standard deviation will be lower for the fixed annuity, but so will its average real rate of return.

Now let's consider the annuity issuer's guidelines that limit the proportion in the variable annuity to no more than 50 percent of the portfolio.[5] The effect of the constraint is to eliminate that part of the AB curve that extends above the midpoint between A's return and B's return, represented on the curve at point D. The return-risk combinations between D and A aren't available because the annuity issuer doesn't currently allow them. The points between C and D are legal and justifiable combinations, depending on the claimant's risk tolerance.

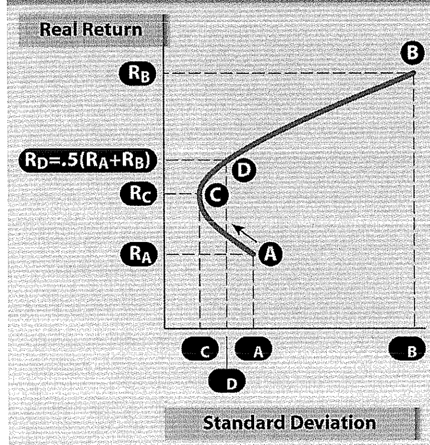
Does this make sense in the real world? Research has demonstrated convincingly that a blend of fixed income investments plus equities offers superior return-risk combinations to a portfolio composed of fixed income investments alone. The longer the time period—and structured settlements involve longer time periods—the better the concept fits.

FIGURE 1

Structured Settlements

Adding a Variable Component Improves Efficiency

Point A represents the fixed annuity, and point B represents the variable annuity. Combinations from A to C are inferior because they are dominated by Point C. Combinations from C to D are efficient/acceptable. Combinations from D to B are unavailable due to annuity issuer's interpretation of the IRS Private Letter Ruling.



More Benefits and a Few Caveats

While consideration of asset allocation within the structured settlement may upset established protocols for resolving injury claims, it is clearly good news for shrewd claimants. The opportunity to fund future income with a balanced portfolio of fixed income and equity investments free from the drag of taxes on interest, dividends and capital gains is a substantial economic advantage that can serve to both increase net returns on the upside and cushion losses on the down.

Of course, no approach is perfect. Structured settlements are subject to certain limitations that affect one's ability to shape the investment strategy in optimal ways. First, the claimant has no ability to control the timing of the investment. A claimant's case settles when it settles, and funds can't be committed until they become available. The nature and timing of future payments must be set at time of settlement and cannot be changed. While lack of choice simplifies this decision, it also precludes dollar cost averaging and restricts one's choices generally.

Second, as currently offered, only an initial asset allocation is permitted because tax rules appear to prohibit reallocation of assets in future years.[6] If the variable annuity outperforms the fixed annuity as expected, a larger and larger percentage of the income stream will come from the variable annuity. The effect is to generate a more volatile income stream in future years, which is of greater concern as the projected life expectancy of the claimant or of the settlement stream approaches. On the other hand, if the income stream becomes heavily weighted in favor of the variable, it must result from the variable performing well.

Third, sub-account choices in existing annuity policies designed for this purpose are limited currently to half a dozen—four managed funds and two unmanaged index funds. Because future quality of management adds another layer of risk and the claimant has no ability to switch out of a poorly performing sub-account, the most sensible choice for most claimants is likely to be the unmanaged S&P 500 index subaccount, which fits in nicely with MPT anyway.

Finally, there are costs to consider. Subaccount returns in the variable annuity are first reduced by investment expenses of .29 percent plus a "separate account charge" of 1.25 percent, according to one sample policy, meaning returns to the claimant will necessarily trail the S&P 500 index itself by at least 1.59 percent annually.[7]

Could claimants do better for themselves by taking cash settlements and investing in mutual funds? Even if they could, taxes and transaction costs would increase the challenge significantly. Odds are not good that, on an after-tax basis, most claimants would match the overall return of a balanced, nontaxable structured settlement allocated 50 percent to fixed income and 50 percent to equities.

Annuitized structured settlements offer three other well-known benefits worth mentioning. First, payments are larger because the principal is essentially allocated over the projected life of the contract. Second, the annuity structure provides built-in spendthrift protection. Third, the annuity provides payment protection for those who will outlive the mortality table, and a measure of comfort even for those who won't.[8]

Structured settlements offer substantive economic advantages to injured claimants if approached properly and should at least be considered in most cases. The longer the time frame for the projected payments, the more beneficial the variable annuity approach. The variable alternative helps ensure that infla-

tion won't devour the claimant's income stream. Indeed, it creates the likelihood that the purchasing power of the income stream will increase as time passes.

Endnotes

1. Per consensus interpretation of Internal Revenue Code Section 130.
2. See Internal Revenue Service Private Letter Ruling #121002-97.
3. Nor can they be in "constructive receipt" or enjoy "economic benefit" of the funds.
4. Claimants commonly fail to recognize that inflation is a devaluation of the currency and that the only remedy is to hold assets with the potential to appreciate at a rate higher than inflation. Constructing a fixed schedule of increasing payments is not a substitute for true growth of the underlying assets. A three percent annual increase appears to offset inflation but is in fact merely a deferral of dollars from early in the term to late. The internal rate of return on the full schedule remains fixed throughout the term.
5. Based at least in part on its interpretation of the IRS Private Letter Ruling. See endnote 2 above.
6. This issue relates to the aforementioned legal doctrines of "constructive receipt" and "economic benefit" whereby a claimant may not have any incidence of ownership or control over funding assets.
7. Per the MetLife Settlement Plus prospectus dated May 1, 2002, p. 6.
8. To the extent injuries are life threatening, it is imperative that "medical underwriting" be requested because it can lead to substantial increases in life-contingent fixed annuity benefits.

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