

HOW TO COMPARE A STRUCTURED SETTLEMENT TO OTHER INVESTMENT OPTIONS

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Comparing tax-free and guaranteed structured settlements to other investment options on the basis of a simple Rate of Return (“ROR”) calculation is inaccurate. A more appropriate means of comparison is a measure known as Internal Rate of Return (“IRR”), which is a measure of the cash inflows necessary to produce cash outflows. For example, in the case of a structured settlement, the cash inflow is the money required to purchase the structure, whereas the cash outflow is the income that the structure produces.

By definition, IRR is simply: “...the intrinsic rate of return that is expected to be derived from an investment, considering the amount and timing of the associated cash flows” [see <http://accounting-simplified.com/management/investment-appraisal/internal-rate-of-return-irr.html>]. For example, an IRR of 2 per cent means that in order to obtain the desired future payments, an invested sum of money will need to generate an average annual ROR of 2 per cent during the full term of investment.

The annual ROR, defined, is what some investment amount (\$X) grows to over the course of a year. For example, if we are looking at a 10-year term, the average annual ROR to grow \$X to \$Y is defined by the formula: $Y = (1+i)^{10} * X$, where i is the average annual ROR. This means that to achieve \$Y in 10 years, the entire investment of \$X, along with any interest earned, must remain invested; nothing can be drawn down from the investment (i.e., no cash outflows or income can be produced).

If money is being withdrawn from the investment to finance a person’s annual needs, even with a constant average annual ROR, the income producible would vary. For example, 5 percent of \$1M is \$50K; if we were to take out more than \$50K a year (because personal needs exceed that amount), the average annual ROR would have to increase to a level sufficient to offset this additional draw down.


EXAMPLE

Assumptions:

1. Injured party is a 55-year-old male.
2. Injury is a moderate traumatic brain injury.
3. Normal life expectancy of twenty-seven (27) years.
4. Life impairment rating of +5, meaning a reduced life expectancy of 22 years.
5. \$1M available for investment.
6. ROR of approximately 5%, or an average of 3% net of tax and fees.

See table on opposite page

So using ROR over IRR to compare investment returns of different types of investment products is inappropriate, particularly in the context of structured settlements. That is, the ROR does not account for cash flows, whereas the IRR looks at how much money you would have to invest in order to produce the income a person will need in future.

It would be prudent for anyone considering a tax-free and guaranteed structured settlement to ask their consultant to compare the IRR of the structure plan under consideration to the IRR of any other investment option being presented. 



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Drawdown of SIM Capital Investment				
Year	Starting Principle	Starting Principle plus 3.0% Return	Annual Amount Required Indexed at 2%	Ending Principle
1	\$1,000,000.00	\$1,030,000.00	\$47,166.96	\$982,833.04
2	\$982,833.04	\$1,012,318.03	\$48,110.30	\$964,207.73
3	\$964,207.73	\$993,133.96	\$49,072.51	\$944,061.46
4	\$944,061.46	\$972,383.30	\$50,053.96	\$922,329.35
5	\$922,329.35	\$949,999.23	\$51,055.03	\$898,944.19
6	\$898,944.19	\$925,912.52	\$52,076.14	\$873,836.38
7	\$873,836.38	\$900,051.48	\$53,117.66	\$846,933.82
8	\$846,933.82	\$872,341.83	\$54,180.01	\$818,161.82
9	\$818,161.82	\$842,706.68	\$55,263.61	\$787,443.06
10	\$787,443.06	\$811,066.36	\$56,368.88	\$754,697.47
11	\$754,697.47	\$777,338.40	\$57,496.26	\$719,842.14
12	\$719,842.14	\$741,437.40	\$58,646.19	\$682,791.21
13	\$682,791.21	\$703,274.95	\$59,819.11	\$643,455.84
14	\$643,455.84	\$662,759.52	\$61,015.49	\$601,744.02
15	\$601,744.02	\$619,796.34	\$62,235.80	\$557,560.54
16	\$557,560.54	\$574,287.36	\$63,480.52	\$510,806.84
17	\$510,806.84	\$526,131.05	\$64,750.13	\$461,380.92
18	\$461,380.92	\$475,222.34	\$66,045.13	\$409,177.21
19	\$409,177.21	\$421,452.53	\$67,366.03	\$354,086.50
20	\$354,086.50	\$364,709.09	\$68,713.35	\$295,995.74
21	\$295,995.74	\$304,875.61	\$70,087.62	\$234,787.99
22	\$234,787.99	\$241,831.63	\$71,489.37	\$170,342.25
23	\$170,342.25	\$175,452.52	\$72,919.16	\$102,533.36
24	\$102,533.36	\$105,609.36	\$74,377.54	\$31,231.82
25	\$31,231.82	\$32,168.77	\$75,865.10	-\$43,696.32
26	\$0.00	-	-	-
27	-	-	-	-
IRR: 3.0% (ROR: 5% gross, or 3% net of tax and fees)				

SIM Structure Investment		
Year	Annual Income Indexed at 2%	Cumulative Income
1	\$47,166.96	\$47,166.96
2	\$48,110.30	\$95,277.26
3	\$49,072.51	\$144,349.76
4	\$50,053.96	\$194,403.72
5	\$51,055.03	\$245,458.75
6	\$52,076.14	\$297,534.89
7	\$53,117.66	\$350,652.55
8	\$54,180.01	\$404,832.56
9	\$55,263.61	\$460,096.17
10	\$56,368.88	\$516,465.05
11	\$57,496.26	\$573,961.31
12	\$58,646.19	\$632,607.50
13	\$59,819.11	\$692,426.61
14	\$61,015.49	\$753,442.10
15	\$62,235.80	\$815,677.90
16	\$63,480.52	\$879,158.42
17	\$64,750.13	\$943,908.55
18	\$66,045.13	\$1,009,953.68
19	\$67,366.03	\$1,077,319.72
20	\$68,713.35	\$1,146,033.07
21	\$70,087.62	\$1,216,120.69
22	\$71,489.37	\$1,287,610.06
23	\$72,919.16	\$1,360,529.23
24	\$74,377.54	\$1,434,906.77
25	\$75,865.10	\$1,510,771.87
26	\$77,382.40	\$1,588,154.26
27	\$78,930.05	\$1,667,084.31
IRR: 3.5% (ROR: 1.91%)		