

MONITOR

Found Money and the Casino Mentality

All too often, personal injury claimants are persuaded by stockbrokers and other financial advisors to invest their settlement money as though it were a windfall (“found money”), risking most of it in mutual funds or a portfolio of individual stocks. The selective projection into the future by many financial advisors of unsustainable rates of equity growth from the past, combined with their self-serving refusal to point out today’s increased level of market volatility and the growing frequency of significant market declines, have led many personal injury claimants to misinvest the better part of their settlement awards.

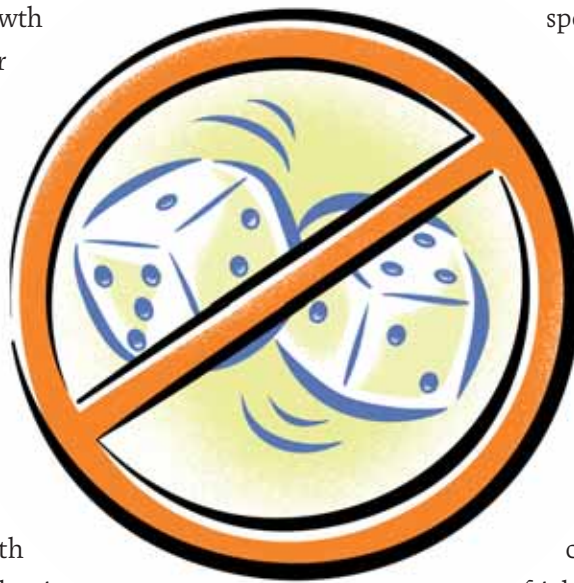
Taking the four most widely followed barometers of stock market performance in North America (namely, the TSE 300 Index in Canada and the Dow Jones Industrial Average, S&P 500 Index and NASDAQ 100 Index in the U.S.), since 1960 (1989 for the NASDAQ 100 – its inception) these indices have experienced three-month declines in excess of 10% on 17 (TSE 300), 12 (Dow Jones), 10 (S&P 500), and 9 (NASDAQ 100) occasions.¹

Many of today’s “swing for the fences” financial advisors and investors deride the lessons of the past, insisting that there is a new paradigm governing today’s stock markets.

If, indeed, such a new paradigm exists, there is nothing to suggest that it will work to the advantage of the average investor. In fact, quite the contrary. With today’s markets characterized by a hyper-sensitivity to corporate earnings and general economic conditions (a hyper-sensitivity exacerbated by high levels of margin speculation, unachievable “whisper numbers”, and the rapid rotation in and out of industry groups by mutual funds), volatility has become the order of the day, resulting in over-sized gains for a few individual stocks and mutual funds but punishing losses for many more.

As measured by the four major indices, the speed and severity of significant market declines in recent years has been frightening. From their highs in early 2000, the indices experienced declines over the following year ranging from 18.8% (Dow Jones) to 34.9% (TSE 300) to 72.1% (NASDAQ) and have taken the five years since to recover. Most claimants need a monthly income from their settlements and cannot wait years before making withdrawals. They have no way of recovering from such steep declines which, if anything, appear set to occur with even greater frequency in the future.

¹ Source: Bloomberg L.P.



The Sobering Effect of Management Expenses and Taxes on Mutual Fund Performance

When singing the praises of a particular mutual fund, financial advisors typically refer to the fund's past performance. In so doing, financial advisors frequently stack the deck in their favour and that of the fund company's, by only citing the fund's gross return for the measurement period in question.

What, in fact, a prospective investor really needs to know in order to properly assess a mutual fund's performance, is the fund's return **net of management expenses and taxes**. For it is the net return, not the gross return, that an investor actually winds-up receiving.

Getting at the net return usually involves a relatively simple two-step calculation. First, one subtracts a fund's management expense ratio, or "MER", for the period in question from the fund's gross return for that period. Second, taking the figure arrived at in the first step, one then subtracts the approximate amount which Canada Revenue Agency (formerly known as Revenue Canada) will take in order to cover taxes on capital gains, dividend and/or interest income. What is left over at the end of the second step, assuming that there are no load charges to contend with, is the net return which the investor will actually receive.

Let us take a closer look at the impact of MERs and taxes on mutual fund performance:

MERs measure the cost to the individual investor of running the mutual fund, including: (i) the management fees charged by the fund manager (chief among which are the salaries and bonuses of the portfolio manager(s), analysts and marketing personnel), and (ii) the ongoing costs of operating the fund (chief among which are trading costs, with most equity mutual funds turning over their entire portfolio more than once a year).

MERs can be as high as 4% or 5% a year, depending on the type of fund. The MER for most equity mutual funds is between 2% and 3%.¹

Taxes can be counted on to claim a further significant portion of a fund's returns, the exact extent of which will depend upon the nature of those returns and one's tax bracket.

Subtracting management expenses and taxes from the gross return of the average equity mutual fund not only gives one a more accurate sense of the actual return that one can expect to receive, it also brings the performance of many a fund back down to earth in a real hurry.

¹ Source: *Consider the Expense Ratio When Picking RRSP Funds* by Olev Edur, *Financial Post*, December 6, 2000.



Slip Slidin' Away

In his text on structured settlements in Canada¹, Professor John P. Weir cites the results of a well-known American study which indicates that within 2 months following receipt of a significant monetary settlement (award, lotteries, sweepstakes, insurance, inheritances, etc.), 25% of the recipients had nothing left. By the end of the first year, 50% had nothing left. By the end of the first 2 years, 70% had nothing left. And within 5 years of settlement, 90% of the recipients had nothing left.

¹ Source: *Structured Settlements* by John P. Weir, Carswell Legal Publications, Toronto.

Bad Advice and Short Memories

Personal injury claimants frequently meet with one of this country's approximately 100,000 financial advisors¹, when it comes time to seek advice on how to invest their settlement money. Often, the financial advisor so consulted is quick to recommend a top performing mutual fund which boasts an enviable track record and holds out the promise of "over-sized" gains going forward.

Such recommendations should be treated with caution. Not only have the top-selling funds from the late 1990's failed to earn the heady returns of the previous decade, people who invested in them have lost 15% of their capital since 2002². Claimants who were dependent on the expected income from the funds have been forced to access their capital to pay living expenses, further eroding it. Even worse,

they have been forced to use settlement money to pay management expenses on these funds. (Please see related article.)

All of which begs the question, if the financial advisor being consulted only recommends winning mutual funds, then who recommended all of these Dogs? In many cases, it is the same person.

Conveniently, the typical financial advisor is blessed with an extremely short memory. No point reminding him or her about last year's or, indeed, even last month's bad piece of advice, for that is long since forgotten.

In an industry where memories are blissfully short, it is unwise to place too much faith in the average financial advisor's "promise" of future performance.

¹ Source: Advisor Impact, ² Source: USA Today

THE SOLUTION – A Structured Settlement

(ELIMINATE RISK AND TAX TODAY!)

Settlement money received by personal injury claimants usually represents many years of lost earnings. Often it must pay for a lifetime of extra medical and care needs. It is money with which claimants simply cannot afford to take risks. The other articles in this Monitor have explained that many ordinary investments are just too risky for settlement money. They have also talked about the risk that, since most people are not used to managing large sums of money, settlement money is often spent unwisely. One day, all too soon, the money which will be needed over the balance of the claimant's lifetime may be gone.

Fortunately, structured settlements offer the ideal solution. They provide a guaranteed, regular stream of income, which claimants can design to meet their particular needs. With a structured settlement, claimants know exactly how much they will get, and when. All of the investment risks are transferred to a life insurance company. Claimants also know that no one, whether well-meaning or not, can get access to their settlement money. The payments can only

be spent one at a time. There is no risk that claimants will wake up one day and find that their settlement money is all gone.

A structured settlement can also include other protections for claimants. It can be designed to pay for as long as they live, so that there is no risk that they will outlive their settlement money. It can incorporate a guarantee, so that the payments will continue tax-free to the claimant's family, should the claimant die prematurely. It can incorporate indexation to provide protection against increasing costs of living or medical expenses.

There are no other investments which provide this level of protection against the risks which a personal injury claimant faces.

When one adds in the fact that structure payments are received on a **completely tax-free basis**, it is clear that a structured settlement is the perfect way to invest settlement money.



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