Secondary Market Annuities:

A Higher Yield, Alternative Fixed Income Asset Class

By Nathaniel M. Pulsifer

In today's low yield environment, where traditional safe assets like CD's and bonds do not yield enough to even keep pace with inflation, investors are increasingly seeking yield in alternative sectors and strategies. Emerging markets, foreign markets, and even lower credit quality corporate debt offer yield opportunity, but in these alternatives, safety takes a back seat in the hunt for returns.

But a little known, high credit quality domestic alternative fixed income asset class does exist, offering investors an opportunity for an enhanced yield without compromising on safety. These are structured settlement backed receivables, colloquially known as Secondary Market Annuities, or SMAs.

Origin of the Secondary Market for Annuity Payments

Secondary Market Annuities come to be when individuals seek to sell their future annuity payments for cash today. Frequently, these payments are structured settlement awards for injuries or legal settlements. Roughly $5B in structured settlements are issued each year, and pay recipients guaranteed income and lump sums as compensation for their injuries.

These awards comply with strict IRS guidelines and are backed by guaranteed, period certain annuities issued by the strongest annuity carriers like Met Life, Berkshire Hathaway, and Prudential. The annuities are fully funded and paid for by the settling parties in lawsuits.

But of course, people's needs change over time, and settlement awards constructed years ago may no longer meet an individual's needs today.

Individuals with future payment streams who need funds today cannot cash in or surrender their annuities directly with the issuing carriers because of the IRS rules associated with structured settlements.

Instead, these individuals must turn to a secondary marketplace, where private parties contract to purchase future payment streams. These transactions assign the existing payments to the new payee in an established and uniform, court ordered, and rigorous legal procedure.

Roughly $1B/ year transacts in this secondary marketplace. Of that, nearly 80% of the available inventory is bundled into asset backed notes securitized on Wall Street and sold to institutional investors, and is therefore unavailable to individuals.

However, there are payments available outside the securitization marketplace and it's in this space that safety conscious investors may find a higher yield on high credit-quality guaranteed payment streams. And it's in this marketplace that we have found an excellent safe money asset class to augment retirement portfolios and create income for our customers.

What Are The Benefits Of Secondary Market Annuities?

Secondary Market Annuities offer all the benefits of a primary market, period certain, guaranteed yield annuity. These are:

- Guaranteed, period certain payments
- No market correlation
- No volatility
- Top quality credit

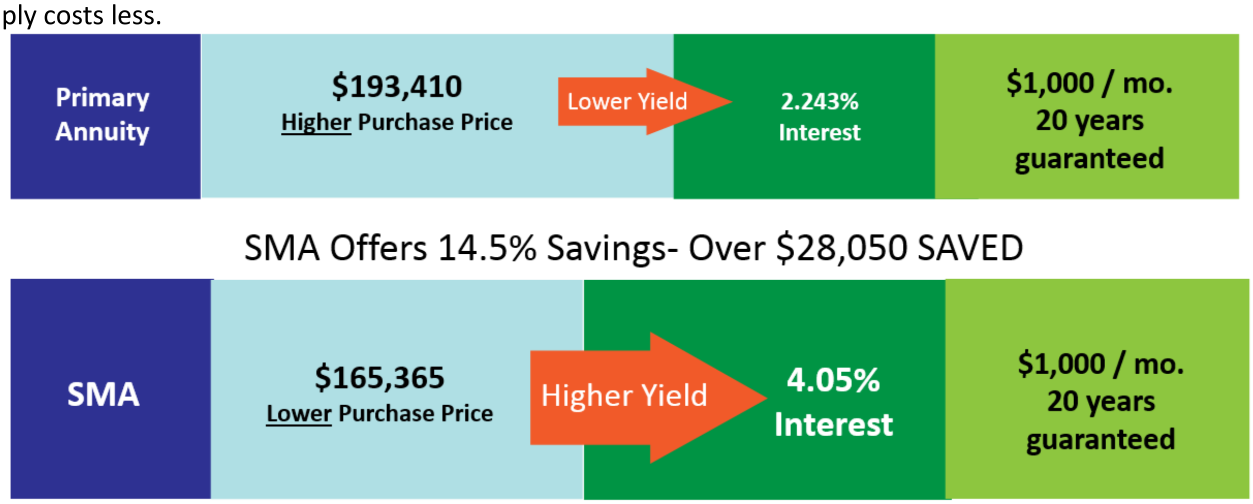
What makes Secondary Market Annuities unique, however, is that all the above elements of safety and certainty that are common to period certain annuities and fixed assets, are available at a higher yield due to the discount incurred by the seller.

Why Higher Yield Means A Lower Price:

A 75 year old couple seeking $1000/ month for 20 years guaranteed will receive quotes in the neighborhood of $193,410. This represents a 2.243% effective rate of return on the purchase price. (Internal Rate of Return)

By comparison, an SMA paying 240 monthly payments of $1000/ month would cost approximately $165,365. This is based on a 4.05% effective rate of return.

The comparison is clear- For the same quality and the same income, the secondary market annuity simply costs less.



$1,000 per month period certain 20 years, vs. SMA.
Rates as of 11/2016 & subject to change.

Now here's the catch- a period certain annuity may be bought with any amount of principal and at any time. By contrast, an SMA is a first come, first served offering and it is at times challenging to find a specific payment stream that is not too big, not too small, and comes around at just the right moment.

Advisors pick from available inventory and match those payments to their clients. In this market, great advisors are much like great real estate agents- they watch the market and know their customers, and call quickly when 'the perfect case' becomes available.

Example Uses of Secondary Market Annuities

Secondary Market Annuities are definitely not for everyone, however as we work with clients nationwide looking for guaranteed income and safe appreciation, Secondary Annuities frequently provide the best option.

Current Income:

For example, retirees looking for income from their accumulated assets are well advised to limit their exposure to market based assets and the associated volatility. Being forced to sell stocks when the market is down to pay monthly expenses is known as the 'sequence of returns' risk, or 'reverse dollar cost averaging'.

But astute financial planners- both individuals and advisors- effectively mitigate this risk by creating guaranteed income to pay those monthly expenses. Guaranteed income takes the pressure off the market based investments and allows them to recover from volatile periods.

Secondary Market Annuities are a great option in this strategy as they produce the necessary floor level of guaranteed income. Because SMA are specific, period certain payments and because they yield more, they simply cost less than other comparable assets like newly issued annuities.

We find that investors using Secondary Market Annuities typically spend 20% less to create the same level of income, and that savings translates into more flexibility in other investments, or into purchasing more income for the same investment amount.

Lump Sums:

Another use of Secondary Market Annuities is as an alternative to CD's.

CD's typically are a good option for savers to hold cash, but with rates as low as they are today, the yield falls behind inflation, leaving investors with less purchasing power after the CD matures.

Current rates on single payment lump sum Secondary Market Annuities offer yields ranging from 3% to 5% for varying lengths of term. These are excellent alternatives to CD's but they are also great options in IRAs for safety conscious pre-retirees, and may also be used in inheritance planning, endowments, planned giving, and other scenarios.

Deferred Income:

A final type of payment typically found in the secondary annuity marketplace is the deferred income stream. These payments, often starting years in the future, defer, accrue, and compound until they start paying out. Deferred income streams are perfect for bucket planning, target retirement dates, or known future expenditures.

For example, a 55 year old may know that Social Security and other income at retirement age will be insufficient for expenses, and wants to augment that income starting at age 65. A ten year deferred income SMA payment stream offers certainty and a guaranteed outcome few other investments offer.

How Payments Are Transferred To New Payees

Recognizing the need for settlement recipients to get cash, 49 states have adopted Structured Settlement transfer regulations that outline how a payee sells some or all of their payments.

While each state varies, the legal procedure requires carrier involvement and involves notices, hearings, disclosures, independent professional advice, and requires a court to rule on whether the sale of payments is in the seller's best interest. Practically speaking there are also extensive background, credit, and lien searches to ensure there are no competing claims to the payments

Industry leader DCF Exchange is a capitalized trading firm acquiring payment streams from diverse sources of origination for distribution through its network of advisor partners. It engages in a rigorous third party legal review of each transaction prior to its own acquisition, and uses an innovative business trust and payment servicing platform to offer purchasers confidentiality, transferability, and transactional certainty.

Risks and realities of Secondary Market Annuities

No investment is without risk, and the following are risks generally associated with Secondary Market Annuities:

The safety of any given payment stream is directly related to the financial strength of the insurance company that issued the annuity and its ability to pay claims over the term of the SMA.   While default risk is rare in insurance companies, it is always a potential risk. Secondary Market Annuities are not bank deposits and are not insured by the Federal Deposit Insurance Corporation (FDIC) or any other federal government agency.

In addition, each payment stream is transferred via a court ordered process with a series of assignments among intermediary parties. There are transactional and contractual risks in this process, however high quality counterparties and thorough buy-side due diligence and third party collateral file legal review helps to mitigate these risks. It's definitely not a 'do it yourself' marketplace.

Also, Secondary Market Annuities are subject to interest rate risk because they are a fixed rate/ fixed term investment. Market interest rates may rise while the rate of return on the SMA is locked in. Secondary Market Annuities are not readily liquid, so should be viewed as a yield to maturity investment. They are definitely suitable only for a portion of an investor's assets.

Finally, Secondary Market Annuities are individual transactions. They are not available in a customized or exact payment configuration, but rather, specific payment streams are sold by sellers and purchased on a first come first served basis. An investor with a goal of $2500/ month for a specific length of time, for example, would typically purchase two or more income streams to achieve the goal.

In summary, Secondary Market Annuities offer investors a high credit quality income stream at a lower price than other comparable offerings. They offer near term guaranteed income that is perfect for immediate retirement income needs, plus lump sum and deferred income payments suitable for longer range planning.

Secondary Market Annuities may be purchased by investors of any age, in both cash and qualified (IRA) accounts, and are available through select advisors. Inventory is limited and first-come first served, but the rewards are worth it.

SMAs offer conservative purchasers an opportunity to earn a higher yield over comparable safe money allocations and strategies. SMAs may play an important role by providing guaranteed income, specific start date deferred income, or guaranteed lump sum payouts, that are otherwise difficult to find on the open markets.

While SMAs are not right for everyone, for a wide range of buyers they make a lot of sense and astute advisors use Secondary Market Annuities as a key tool in their planning arsenal.

Investors seeking a higher yield on their safe money assets should consider Secondary Market Annuities for their income and capital appreciation needs.

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Nathaniel M. Pulsifer is a market leader in Secondary Market Annuities. He has used the asset class in hundreds of retirement portfolios through his planning practice.

In addition, he is the founder and President of The DCF Exchange, a wholesale trading company that acquires Secondary Market Annuity payment streams for retail distribution through financial advisors nationwide.