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Why Internal Rates of Return Matter So Much

Figuring out the internal rate-of-return is critical to an effective Social Security strategy, one that's coordinated with the overall retirement portfolio. Here's why

By **William Meyer**

Apple-to-apples, level the playing field—pick your metaphor. In its simplest sense, calculating the internal rate-of-return is a way to evaluate the effectiveness of two seemingly disparate investments over time.

If a client puts $1,000 in the bank, the bank pays them interest, and one year later they have $1,042. In this case it is easy to calculate the rate of return at 4.2%. Simply divide the gain of $42 into the original investment of $1,000.[1]

Simple, right? If only it were so. Calculating the rate-of-return shouldn't cause anyone to break a sweat. As usual, it's the older sibling, or the internal rate-of-return (IRR) that's causing all the problems.

More specifically, an investment's IRR "is the interest rate (also known as the discount rate) that will bring a series of cash flows (positive and negative) to a net present value (NPV) of zero (or to the current value of cash invested). Using IRR to obtain net present value is known as the discounted cash flow method of financial analysis."[2]

A quick perusal of explanatory websites like Mathisfun.com and Business-analysis-made-easy.com show them to be a big bunch of liars, with IRR equations and examples more complicated than antiholomorphic functions or anything seen on a recent episode of The Big Bang Theory.

The reason for the complexity stems from differences in the timing and variation of the investments' cash flows. Because they stubbornly fail to return the same amounts at the same time, computer programs are needed at best to figure it out, or at the very least a financial calculator. IRR calculators ranging from the rudimentary to the comprehensive can also be found on the Internet. The point is that figuring out the IRR is incredibly important to an honest appraisal of investment performance, and advisors can rarely figure it on their own.

IRR is calculated at the corporate level to determine investment allocations for capital projects. Specific to the individual, it's used in the aforementioned comparison of two different, yet appropriate investment vehicles or strategies for the client. And for the purposes of our discussion, it is very effective in determining the value of claiming Social Security early and reinvesting the proceeds in the stock market for a higher rate of return, as opposed to delaying the start of benefits for a guaranteed 32% (if begun at age 70). It can also provide an accurate comparison of Social Security and "like-risk" investments such as treasury inflation protected securities and certain deferred annuity products.

The proper asset allocation, as well as asset location, coordinated with an optimized Social Security planning, can result in between two and 10 years of additional portfolio longevity—a material amount. This is why understanding and including an IRR calculation is so important in determining the right strategy for clients.

About William Meyer

Bill Meyer is founder and managing principal of Social Security Solutions, a leading Social Security software firm with patented technology that is dedicated to educating and assisting financial advisors and their clients in optimizing their Social Security claiming strategies. More information is available at www.SSAnalyzer.com.

1. *"Calculate Internal Rate of Return to Compare Investments." Moneyover55.about.com. 2014.*
2. *"Internal Rate of Return: An Inside Look." Investopedia.com. 2014.*

About Social Security Solutions

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