Life Insurance as an Asset Class

Richard M. Weber, MBA, CLU, AEP ® (Distinguished)

1. Life Insurance Basics

A. What is the right price to *pay* for life insurance (when no one wants to pay more than they have to)?

i. The answer is predicated on knowing "how long will you *need* life insurance?"

ii. Short term / intermediate term / lifetime *price* for a 33-year old healthy male

iii. Value statistics

a. Regardless of the starting age, term insurance will cost approximately 70% of the death benefit through life expectancy
b. Term life insurance cannot effectively or affordably provide insurance for the entirety of one's life, unless we are unlucky enough to die substantially before life expectancy.
c. The inevitability of *adverse selection* makes the long-term cost of term insurance much more than the equivalent *net amount at risk* under a permanent policy.

2. Matching permanent policy "styles" to the customer's investment risk tolerance

A. Whole life is generally comparable to the "style" of the conservative investor who is mostly intolerant to volatility and seeks guarantees in most investment choices.

i. Underlying investments are government and high-grade corporate bonds

ii. Premiums are guaranteed

iii. Policy itself is guaranteed

iv. There will be some "upside" potential, but magnitude is not guaranteed

B. No-lapse guarantee universal life is also generally comparable to the "style" of the conservative investor – intolerant of volatility and seeks guarantees

i. The death benefit and premium obligation are guaranteed

ii. Bare bones; "what you see is what you get"

iii. No upside potential for death benefit

C. "Traditional" universal life is generally comparable to the "style" of the balanced investor – tolerant of modest volatility and willing to accept fewer guarantees in favor of premium payment flexibility

   i. The risk of premium "sufficiency" has been shifted to the policy owner

   ii. Policies should be funded with more premium than an illustration is likely to suggest

   iii. No ability to manage the policy owner's risk (premium sufficiency) except by paying more premium.

D. Variable universal life is generally comparable to the "style" of the growth or aggressive investor – tolerant of volatility and willing to lack of guarantees in favor of having the opportunity to manage the underlying investments supporting the policy

   i. The risk of premium "sufficiency" has been shifted to the policy owner
   ii. Policies should be funded with substantially more premium than an illustration is likely to suggest

   iii. Professional management of underlying investment accounts is imperative

E. Equity Indexed universal life is generally comparable to the "style" of the "conservatively aggressive" investor – intolerant of volatility yet desiring the "attractive impossibility" of no downside - without understanding the dynamics of indeterminate pricing.

   i. The risk of premium "sufficiency" has been shifted to the policy owner

   ii. Policy "premium" should be calculated with 5-6% return assumption

   iii. Policy needs to be constantly monitored for premium sufficiency

4. The policy "Illustration Beauty Contest" - the attractive *impossibility* versus the less attractive *probability*

A. $6,000 or $12,000 premium per year - which would you pay?
B. The illustration dilemma: how it's portrayed versus how it really works

C. It's all about your minimum threshold for risk

5. Modern Portfolio Theory (MPT), Asset Classes, and life insurance

A. Introduction

i. Diversification is at the heart of MPT

ii. Correlated versus uncorrelated assets

B. MPT essentials

i. Assess a portfolio into component "asset classes"

ii. Traditional classes

iii. Diversify with dissimilar categories

C. Life insurance as an asset class

i. Death benefit is cash

ii. Living benefits – cash value –take on the asset class attributes of the underlying policy style: whole life = fixed

iii. Life insurance has unique attributes that keep it in a category by itself

a. income tax-deferred accumulation of cash value
b. income tax-free death benefit
c. estate-tax free planning opportunities
d. free from reach of creditors
e. inherent leverage of premium to death benefit
f. death benefit is triggered by the event of death; no market value adjustment
g. policy premiums should be allocated out of investment portfolio assets

h. permanent life insurance can produce a favorable long-term return with less risk within a portfolio of equity and fixed components

D. Life insurance as a value-added component of the fixed component of an asset allocation

i. $500,000 municipal bond example

ii. Risk Index explained

iii. Needed life insurance can reduce risk and increase overall return of portfolio

iv. Two strategies for enhancing retirement income

v. Inherent leverage of premium to death benefit

vi. Death benefit is triggered by the event of death; no market value adjustment

vii. Policy premiums should be allocated out of investment portfolio assets

viii. Permanent life insurance can produce a favorable long-term return with less risk within a portfolio of equity and fixed return components

6. Further affirmation of Life Insurance as an Asset Class - Thornburg Investment Management's "A Study of REAL Real Returns" - Dec. 31, 1979 - Dec. 31, 2009

A. Growth of $100 to $2,440 in 30 years at S&P *nominal* return of 11.24% becomes a *Real* Real return of ...

i. 10.68% (and $2,101) after *investment expenses*

ii. 9.28% (and $1,432) after taxes on *dividends*

iii. 8.90% (and $1,292) after taxes on *capital gains*

iv. 5.21% (and $459) after the depreciating effects of *inflation*

B. Similar effect on the growth of other asset classes, for example ...

i. 7.54% Municipal Bond return becomes a *Real* Real return of 3.33%

ii. 9.68% Long-term U. S. Treasury return becomes a *Real* Real return of 1.94%

iii. 9.20% Corporate Bonds return becomes a *Real* Real return of 1.28%

iv. 5.49% U. S. T-Bill return becomes a *Real* Real return of *minus* 1.00%

* Par whole life with annual premiums of $18,365 paid for 25 years on a $1 million policy issued to a 40-M-Best Class in 1986 and held through 2010. The policy produced a total cash value (including cash value of paid-up additions) of $946,676 representing a pre-tax IRR of 5.19%. The cash value accumulation in a par whole life insurance policy is net of expenses and taxes, leaving only inflation to be accounted for.

- The *Real* Real return of the cash value portion of a participating whole life insurance policy acquired and held between for the entire 25 years between 12/31/1985 and 12/31/2010 had a nominal premium-to-total cash value return of 5.19%.

- Taxes and expenses are *net* of the nominal return of 5.19%, leaving only inflation to be accounted for.

Asset Type	*REAL* Real Return	Nominal Return
Domestic Large Cap	5.21%	11.24%
Domestic Small Cap	4.81%	10.36%
International Stock	4.55%	10.21%
Municipal Bonds	3.33%	7.54%
Long Term Gov. Bonds	1.94%	9.68%
Cash Values*	1.68%	5.19%
Corporate Bonds	1.28%	9.20%
Intermediate Gov. Bonds	1.06%	8.40%
Real Estate / Single Fam Home	0.36%	4.49%
T-Bills	-1.00%	5.49%
Commodities	-3.50%	0.46%

- The *Real* Real return of the cash value was 1.60%, comfortably confirming that it is representative of a reasonable return within its asset class category.

7. Efficient Choices

A. Introduction

i. The sophisticated form of diversification under MPT is Efficient Frontier Analysis

ii. A similar process can be applied to the efficient selection of life insurance policies intended for lifetime uses

B. MPT indicates that appropriate diversification is how investors maximize returns for a given amount of risk tolerance.

i. The sophisticated form of diversification under MPT is Efficient Frontier Analysis;
ii. A similar process can be applied to the efficient selection of life insurance policies intended for lifetime uses

C. Dominant attributes/qualities of life insurance policies

i. "Price" (premium outlay);

ii. "Cost" – (the net of the premium outlay and resulting cash value;

iii. Likely death benefit (as generated by dividends or the cash value "pushes" the IRC Sec. 7702 "corridor");

iv. Any risk (to the policy owner) associated with the investments used to support the policy reserves. The specific mixture of these attributes result in a "style" of policy.

D. Attributes assessment matrix

	Price	**Cost**	**Increases in Death Benefit**	**Investment Risk**
No Lapse UL	Lowest	Highest	None	Lowest
Universal Life	Low	High	Some	Low
Variable UL	High	Low	Good	High
Par Whole Life	Highest	Best	Excellent	Very Low

E. Using the Efficient Choices Matrix

i. Buyer's focus

a. If an insurance buyer's focus is on lowest actual outlay, the healthy male non-smoker might acquire NLG, yet for best cost, he might consider WL or VUL. Similarly, if his risk tolerance is relatively low, consideration of the amount of inherent risk might dictate NLG – yet this style can produce the highest cost. No one style contains elements that will satisfy the various combinations of considerations.
b. The starting point for selecting amongst a range of policy styles is to determine the appropriate amount of policy investment "risk" the buyer is willing to take. (It is assumed that carrier selection will depend heavily on financial stability, therefore we will focus solely on the investment risk underlying the selection of a policy style).

ii. Buyer's risk tolerance

a. As suggested in the above table, NLG has no investment risk (that is to say, the investment risk is the insurance company's and not the policy owner's – unless of course the adverse investment experience is so severe that the carrier becomes insolvent). Assuming the selection of a financially superior insurance company, we would assign NLG a "Risk Index" of 0.
b. At the other end of the spectrum, a VUL entirely utilizing an S&P500™ Index sub account typically has a standard deviation (a measurement of risk) of 15%; we would assign such a VUL allocation a "Risk Index" of 15.

iii. Combining buyer's focus and risk tolerance

a. Participating whole life is comprised of two components: the underlying guaranteed policy which, as with NLG has no explicit investment risk, and a non-guaranteed dividend whose risk of meeting dividend projections is most closely associated with an investment in investment-grade bonds. As indicated in the last section, we assign a "Risk Index" of "1.8" to participating whole life (blending the underlying guarantees of the base whole life policy with the bond-like portfolio returns of the non-guaranteed dividend scale).
b. Because the UL policy doesn't offer sufficient unique or advantageous attributes compared to the other policy styles, it will not be considered in this context.
c. The Matrix of Risk Indices (found on the last page of this outline) demonstrates all the possible ratios of NLG, VUL, and Par WL as components in a portfolio of policies ranked by "Risk Index." For ease of explanation, we will divide the range of "Risk Indices" into 4 narrative labels: Conservative (0 to 3.9), Balanced

(4.0 to 7.9), Growth (8.0 to 11.9), and Aggressive Growth (12 to 15). Note that these are Risk Indices and not rates of return.

iv. A process for determining a reasonable, responsive, and effective blend of policies for maximization of desired qualities would be as follows:

a. What is the risk tolerance and time horizon of the insurance buyer, using the labels described above? For the first example, we'll assume that the response is "4" – in other words, the lowest range within "Conservative" (and comparable to a 20/80 mix of fixed and equity asset classes in a general portfolio).
b. Determine which of the following is the greater priority: Lowest premium outlay, development and access to cash value, or the ability to generate excess death benefit. Since the existence and access to cash value is closely linked to the ability to generate increases in death benefit (Section 7702 of the IRC) we will combine the cash value and death benefit criteria for the following choices:

1. Lowest premium outlay; or
2. Development and access to cash value and subsequent ability to generate excess death benefit

v. From the Risk Index Table, select the a matrix ranging from 3 steps below to 3 steps "above" the Risk Index closest to "4."

vi. Example - "Balanced" Risk Index

a. Here we assume that the prospective buyer of life insurance indicates a Risk Index of 7 (comparable to a 60/40 mix of equity and fixed asset classes in a general portfolio).
b. With a view to the different "mixes" of product styles in the chosen risk matrix: if lowest premium outlay is the greater priority, we'll focus on the NLG column and maximize the amount of NLG suggested in the matrix. This results in 50% NLG with the accompanying 0% WL and 50% VUL.

Par WL	NLG	VUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

vii. If, on the other hand, availability and access to cash value – as well as the potential for an increasing death benefit over time – is of greater importance, we'll focus on the Par WL column and maximize the amount of WL suggested in the matrix. This results in 60% WL with the accompanying 0% NLG and 40% VUL.

Par WL	NLG	VUL	Risk Index
30	30	40	6.54
40	20	40	6.72
50	10	40	6.9
60	0	40	7.08
0	50	50	7.5
10	40	50	7.68
20	30	50	7.86

8. In the real world: yesterday's new policy is today's "in-force" policy: Assessing and managing *projection-priced policies*

A. In-force view 10 years after purchase

i. 10th year cash value illustrated as $64,510 "on the curve"

ii. Actual 10th year cash value $60,513 and age 88 lapse

iii.

B. Remediating in-force policies

i. Monte Carlo premium remediation = $15,073 (90% confidence)

ii. Monte Carlo death benefit remediation = $650,000 (90% confidence)

C. Life Settlement or surrender

i. Generally practical when review of medical records suggests a specific life expectancy of less than 150 months

ii. Under certain circumstances, may facilitate a more financially favorable exchange to a new policy

D. New policy to replace "failed" policy

i. Generally effective only if shifting style

ii. Big debate whether "more modern" scale of COI makes sufficient difference to begin with new sales charges, surrender charges, contestable period, etc; begs "migration to mean" expectation

iii. 1035 Exchange + annual premium of $10,530 No-Lapse Guarantee

iv. “I don’t want to pay more for life insurance than I have to!”

E. Personalized longevity study gives policy owner valuable funding information

i. LE “shift” information gives policy owner valuable funding information

ii. Other uses, including

a. timing of Social Security benefits
b. retirement income distribution
c. long term care decisions
d. reverse mortgages
e. immediate annuities

F. Internal Rate of Return analysis on Death benefit

i. $1 million vs $2,796,000 life expectancy death benefit 10.13% IRR

ii. $1 million vs $5,891,000 age 100 death benefit 9.55% IRR

9. Policy management

A. “Not your father’s Oldsmobile” - or life insurance policy

i. Life insurance is property. It should be managed as any other asset.

ii. Expect to pay for expert management advice

iii. Insurance companies are *not* providing analytical tools or data. You’re on your own.

B. Trustees of ILITs are especially vulnerable in defending their fiduciary obligations

i. Life Insurance Investment Policy Statement

ii. Periodic evaluation to determine if policies continue to be suitable and meet expectations

iii. Are premiums sufficient to sustain policy?

iv. Have variable accounts performed within an acceptable range for the asset classes and planned asset allocation?

v. Have carrier financial ratings deteriorated? Should anything be “done” about that?

vi. Examine remediation alternatives

vii. Actuarial evaluation is critical

viii. Seek periodic review from agents

ix. VUL policies should only be considered if the underlying sub-accounts are professionally managed

To obtain a PDF version of ***Life Insurance as an Asset Class,*** please email a request to

Dick@EthicalEdgeConsulting.com

The Ethical Edge, Inc.
25A Crescent Drive - # 415
Pleasant Hill CA 94523
510 868 8804