

Life Insurance as an Asset Class

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I'm sure you've shared this experience: Your prosperous client, "Frank," likes you and your ideas. You've discussed the pros and cons of your life insurance recommendation, and the client enthusiastically responds, "Looks great! Let me run it by my . . ." Well, you fill in the blank here—attorney, accountant, investment guru, plumber. Frank goes on to say, ". . . and assuming 'he' doesn't have any concerns, we're ready to go!"

Does that bring up any painful experiences or memories?!

What we're going to do today is learn a new language, one that has a much higher probability of getting the result you want and the result that's generally in the client's best interest. While it may also be useful with some clients, my intention is to focus on non-insurance advisors because they're generally the gatekeepers of a lot of high-end client relationships. And I should point out that it's not a *foreign* language you'll learn; you're not going to have to buy a Rosetta Stone program! What I intend to demonstrate has the benefit of being a language the typical advisor already knows. It's the language of financial planning. What you'll see and hear is how the terms of art, some simple mathematical processes, and narrative can be useful in the conversation about life insurance, allowing you to get past some of the myths and clichés that non-insurance advisors seem to pick up out of thin air.

Here's a one-off example between the agent (we'll call her "Carolyn"); and the estate planning attorney (we'll call him "Charlie"). After the pleasantries about the weather and the local sports franchise, Charlie starts the conversation by saying, "You know, Carolyn, I've got just one problem with your proposal. As I predicted to Frank, you've recommended a big, fat whole life policy, and anyone who pays attention to the smart financial guys knows that term insurance is usually the *only* policy anyone should consider."

Carolyn responds,

Charlie, I think I know where you're coming from! Term life insurance is cheap, and whole life is expensive. Do I have that right? Well, you may be right, but let me ask a question. Can I assume it wouldn't bother you if our client died just months after he decided he could no longer afford the term

insurance once the guarantee period was over? Yes? It *would* bother you? So the real question I guess we should address is, How long is he going to need it? If you'll indulge me for just a couple of minutes, let me show you an example of how we evaluate cost-benefit in the long-term and also how we think through the kind of life insurance that should make sense for a given situation.

My example is to look at what it costs the wholesaler (the insurance company) to be "on the risk" of a death benefit for various periods of time, regardless of what kind of insurance it is. It all tracks with life expectancy. In insurance-speak, life expectancy is the point where half of an original group of people has died and half are still alive. If you were to tell me our client has a relatively short-term need for life insurance, say 20 years, you're probably not surprised that the insurance company will have a fairly minimal cumulative exposure of about \$12,000 for the risk of paying \$1 million during just those 20 years. [visual]

They might charge you \$15,000 for term for that period (they need to pay rent and salaries and put a little aside for profits), or at the other extreme, you might be charged \$200,000 for 20 years of whole life coverage. I get why that *seems* ridiculously disproportionate by comparison. But the essential question is, How long will our client *need* life insurance? What if it's for 30 years, not just 20? An insurer's cumulative risk exposure is another \$16,000 on top of the \$12,000, just to add ten more years of providing coverage, and I'm sure you realize that makes sense because the guy's getting older. [visual]

But let's assume we reach the conclusion with the client that there's no end to the need for coverage; the consideration of legacies, special needs trusts, estate liquidity, and charitable interests all point to this client needing life insurance for as long as the client lives, no matter how long he lives. If we were to measure that period of time by average life expectancy, we're now considering approximately 48 years and not 30 years. What do you think that cumulative cost to the insurance company might be to stay on the risk that long, irrespective of the kind of policy?

Okay, let's help Charlie out. What is the cumulative risk cost to an insurance company from ages 33 to 81 for a \$1 million policy? Do I hear \$100,000? \$200,000? \$300,000? In fact, it's \$690,000! [visual]

You know, Charlie, this surprised me as well. By the end of the period from age 33 to age 81, the insurance company had to set aside a total of almost \$700,000 to make sure that as each year went by, it could meet the death claim. And we found out that this is not some anomaly with 33-year-olds but from *any* starting age to average life expectancy. The insurance company's internal cost is 70 percent of the death benefit! And most people think they'll live longer than the average. Can you imagine what an insurance company's set-aside reserve amount would be considering age 100? It's over \$4 million per \$1 million policy—and that translates to a *premium* no one is likely to pay!

So let me suggest that the objective answer to the question “How long will you want and use life insurance?” leads someone with the resources and long-term perspective to look at the alternatives to \$690,000+ to \$4 million+—even for a term premium after loading for profit. And looking back, that \$200,000 of cumulative premiums over 20 years for whole life that seemed so expensive? That's probably the *lifetime cumulative maximum* outlay (subject to undulations of dividend scales), and the death benefit may well double or triple by life expectancy. From the view of an 81-year-old—or a 99-year-old—with resources to buy either type of policy, whole life and its variations designed for a lifetime of affordability may not be the bad choice many people originally assume!

In our planning firm, what we've realized for some time is that to really talk about the kind of policy that will best meet our clients' needs only *starts* with price and quickly moves on to long-term value and sustainability. And that should be compared to our clients' general tolerance for risk. Frank told me, and I assume he's told you the same thing, that he's a pretty conservative investor. He takes enough risk in building his business and doesn't want to mingle business risk with what it takes to secure his family's future if he's not there to be part of it. I “map” that risk tolerance information to the types of policies that are out there today, guaranteed and non-guaranteed, and Frank presents more like a guaranteed kind of guy. That's what would open the conversation to whole life and possibly guaranteed death benefit policies.” [And, we might add as a quiet aside, it's not just a salesperson's knee-jerk response!]

Okay, let's think about the language I've been using: “risk tolerance” and “conservative versus aggressive” and “long-term versus short-term” and a visual understanding of life expectancy. And you'll recognize that the combined use of numbers and graphics conveys information that's useful and actionable for the client or a typical advisor, compared to an 18-page illustration with all those columns of numbers. Let's also talk about

risk mapping—taking the client’s self-professed risk tolerance and mapping it to a style of policy that would be suggested by that risk tolerance. For example, after explaining the difference between guaranteed design and current assumption design policies, I will recite what I believe to be the appropriate “risk and management statement” that describes the client and the particular style of policy, along with a brief explanation of any risks that the advisor should be aware of that underlie that style of policy. So UL, VUL, and indexed UL all share the virtue of flexibility in premium amount and timing, but less often do you hear and visualize the explanation that the UL policy owner is inherently accepting back a significant amount of the risk she or he assumed she or he was shifting to the insurance company, namely the sustainability of the policy until death whenever it might occur. At the very least this will invite discussion and an opportunity for the client and the advisor to be certain that’s what they want to do.

Have you ever sold a variable universal life? Did it meet your expectations? Your client’s? Many insurance professionals became disillusioned with that style of policy because while performing well in “up” years, it often didn’t withstand very well some of the more extreme “down” years, especially if the planned premium was based on a 12 percent return expectation so prevalent in the 1990s.

Think back to *why* we proposed the original planned premium calculated at 12 percent. Clients most often were looking for “cheap” insurance, and we were battling the “buy term and invest the difference” mantra. And, from the other perspective, if we were trying to build in some additional value to withstand stock market downdrafts, for all our good intentions we didn’t have a particularly good way of avoiding the scenario that when we proposed a reasonable premium, there always seemed to be someone with a “better” one. I’ve come to adopt a sentiment from Aristotle: “We’re drawn to the attractive *impossibility* rather than the less attractive *probability* .”

Once again calling on the language and tools of financial planning, let’s consider a Monte Carlo analysis of the “other agent’s” suggestion that you shouldn’t have to pay \$12,000 when you could “have the same thing” for \$6,000. [visual]

For this 45-year-old healthy man, we’re going to ask for his likely asset allocation, not his expected average return. Assuming the answer is “all equity,” we’re going to take the last *actual* 660 monthly ups and downs of his all-equity allocation (using the S&P 500 as a proxy) and write all those monthly up and down returns on

individual bingo cubes. After giving it a good spin, we'll draw a cube out of the cage, and that's the "credit" for the calculation of the first month of the first year of the first of 1,000 hypothetical illustrations the computer is going to calculate—in about ten seconds! And what we're looking for is the number of times out of a thousand that the illustrations *sustain* to age 100, all the while testing that \$6,000 planned premium. What do you think? How many hypotheticals will make it? [visual]

It turns out that roughly 400 make it, which is more than most insurance folks guess. But what about the ones that didn't make it? Right, 600 *didn't* make it, and that's a 60 percent failure rate. I assume no one here is interested in that kind of result for the life insurance that's protecting our families.

Now let's be clear—this is not a slam on variable universal. It's a slam on *underfunded* variable universal and an underfunding that derives from the regulated illustration calculation process. So let's not talk about buying insurance on the cheap. Let's talk about buying it according to our resources, short-term and long-term liquidity needs, risk tolerance, asset allocation, time frames of need and uses, and issues around probabilities of success: things that financial planners talk about with their clients.

If I were to ask you "What's the minimum threshold of that probability of success you or your clients would typically be willing to accept?" what is it? Eighty percent, 90 percent, 100 percent?" If it were 80 percent, how much do you think the premium would have to increase over \$6,000 to achieve an 80 percent probability of success rather than just 40 percent? [visual]

And how much would you have to plan on paying if the targeted probability is 100 percent? [visual]

Interesting! \$12,000! Which, by the way, is roughly what a modern whole life policy would cost!

Take a moment to think about the dynamics underlying this conversation. I asked the client for her threshold of comfort, and based on her reaction I responded with an estimated funding premium that statistically meets her requirements. I also explain that this isn't the "correct" premium, and it's certainly not the "guaranteed" premium, even if it's meeting a 100 percent expectation. It's the funding premium we're going to start with, and then we'll manage the policy and the necessary funding premium as the years go by, just as we would have

managed a defined benefit contribution, assuming any of you are old enough to remember defined benefit pensions!

By the way, since I can safely bet that none of your broker-dealers will allow you to make these calculations on your own or even with commercial software, let me give you a handy way to translate Monte Carlo into average gross returns in a VUL illustration. First, ask clients about their likely long-term asset allocation, not their assumed interest rate return. Second, translate that response into a gross return for purposes of using the illustration software as a planned premium calculator as follows: An all-equity sub-account strategy should use no more than a 7 percent gross return; an 80/20 should use no more than a 6.5 percent gross return, and a 60/40 should use no more than a 6 percent gross return. And if clients intend an asset allocation of less than 60 percent? I would gently suggest they consider a non-variable flexible premium product because the expenses priced into VUL is geared to the higher return potential of more substantial amounts of equity! Using this same process for indexed UL, I recommend an illustration crediting rate of no more than 5 percent for the purpose of calculating an initial planned premium for a one-year point-to-point S&P 500 index.

Well, all of this preliminary language lesson in financial planning speak is just to get ready for the broader issue of life insurance as an asset class. I want to make the non-insurance advisor comfortable that I'm using her or his language and understand how she or he measures the important variables in a client's considerations. I'm going to talk briefly about Modern Portfolio Theory (MPT) and its inspirations about diversification, and we'll talk about the attributes of an asset class and whether we can find applicability to life insurance cash values as well as death benefits.

So imagine you're drawn to the automotive sector and decide to buy 500 shares of Chrysler and 500 shares of Ford. Is that diversification? Perhaps in a limited way, but in the language of financial planning, it's not well diversified even though they're different stocks because they're *correlated assets*, meaning that external events and economic conditions are likely to affect both in the same way. Imagine if Escalade were a stock and Humvee were a stock, and imagine what the stock value is likely to be when gas prices rise or fall. As you see in the following chart, the stock *values* are in lockstep. [visual]

With higher gas prices, the value of companies making guzzlers goes down. With lower gas prices, the value of the shares goes up. Now imagine that we have Escalade as a stock and Prius as a stock. That's where we get

more of what the investment folks call “negative correlation”—where gas goes up and Prius sells out and Escalades go wanting. [visual]

On the other hand, where gas prices go down, the Prius lots stay full and Escalades are again in demand. An even more extreme example would be Escalade and Schwinn because if gas were to get to \$20 per gallon, we can expect a lot of people leaving their cars at home and finding alternative modes of transportation!

That’s a description of the modern approach to diversification, and Harry Markowitz and two others received the Nobel Prize in 1952 for their 40-year work in developing Modern Portfolio Theory. It’s derived from a very simple approach: Assess your portfolio into the three major asset classes of cash, equities, and fixed income, and then diversify among those classes in a way that meets your risk tolerance while at the same time allowing you to moderate the effects of big swings in the market because of the unique balanced portfolio you’ve built within your tolerance for risk in the equity and fixed-income markets.

So is life insurance an asset class? Let’s break it down into its two major components: the protection for which life insurance is unique as a financial asset and the underlying cash value of a policy intended to provide lifetime coverage. Certainly for the death benefit (all cash) we can agree that it falls into an asset class category. What about the cash value? Well, if it’s a whole life or well-funded traditional UL, the insurer’s underlying assets that create the accessible cash value derive from fixed income investments of the insurer, typically US government bonds, high-grade underwritten mortgages, high-grade corporate bonds, cash, and policy loans, the total of which is generally 90 percent of a typical life insurer’s assets. As a result, this would suggest that cash values from those types of policies are similar to, indeed equal to, cash and fixed income asset classes. On the other hand, if a client owns a well-funded variable UL and keeps most of the account value in equity sub-accounts, then we can agree that the policy’s cash value maps to the equity asset class. Indexed UL falls somewhere in between.

There are lots of other considerations making a lifetime-use life insurance policy unique in its own right: tax-deferred cash value accumulation, income tax free death benefits, ease of maintaining the policy outside the estate and therefore making it outside the estate tax (in some states the policy and its cash value is outside the reach of creditors), and, of course, the inherent leverage of an annual premium (often just 1 percent of the death benefit) to pay for it. These are the significant characteristics with which we’re all familiar, but sometimes we

forget to emphasize them as primary attributes of an asset class that is quite unique for all of the reasons I've just mentioned.

One of the attributes of a death benefit is that it is paid in cash and that has taken on new meaning since the financial near collapse of 2008–2009. Life insurance death benefits aren't susceptible to market value adjustments—it's 100 percent cash for all the things for which beneficiaries need cash and the wherewithal to replace human life value in the event of premature death.

This is a good time in the conversation to point out that I am not advocating for life insurance as an investment. In some cases it may be, but that's not the point of life insurance as an asset class. Rather, when we buy life insurance for all the traditional reasons people buy it, we should treat the acquisition as we would any other investment. In other words, it should have a contextual place in our overall plan and it should be managed on an ongoing basis, as we would any other investment. Which raises the intriguing premise that the premium for such a policy should come out of the investment portfolio and not the client's entertainment budget!

Let's consider a hypothetical portfolio example and see if we can't breathe some life into this consideration of life insurance as an asset class. Let's assume our client "Frank" has a diversified portfolio of investments and within the fixed income category he has a \$500,000 30-year municipal bond paying 4 percent (\$20,000) in yearly, tax-free income. With his decision to accept your proposal for an additional \$1 million policy, we have the opportunity to consider the obvious implication of "life insurance as an asset class": If the insurance is part of his overall investment strategy, then the life insurance should be considered to be a part of the portfolio and the premium should be paid by the portfolio. Frank's choices are to let the \$20,000 bond income at the end of the first year buy more muni bonds—which was his original plan before the discussion of life insurance—and those bonds could accumulate to a total bond value of \$3 million or more over the next 45 years. Or the \$20,000 could be used to pay the premium on the new life insurance policy, keeping the value of the muni bond segment of the portfolio at \$500,000. [visual]

As you'll see in the this chart, the bond value by itself would have grown a little faster under the original concept for the first 17 years or so, but thereafter the benefit of the cash value plus original \$500,000 bond value becomes the clear winner. All of this is just about the accessible cash value of a par whole life policy. On the

other hand, if we look at the portfolio from a death benefit standpoint, obviously life insurance provides superior value throughout. [visual]

Either way there's an advantage to cash value life insurance in the portfolio when there's a lifetime need for life insurance. Of course, we can't just look at potential rewards from either of these strategies, letting the bond grow or letting it pay for the life insurance, without accounting for any risk that might underlie the options. Why do we need to take risk into account? Well, most recently, because of scoundrels like Bernie Madoff! So that's why we bring in the notion of a risk index, in essence assigning a numerical value to the familiar categories of "Conservative," "Balanced," "Aggressive," and "Very aggressive." [visual]

This chart shows the economic benefit of the bond, its 4 percent return against its assessed risk; a pretty low-risk index of 2.48 that incorporates the rating agencies' view of financial strength of the bond issuer; and the 30-year duration of the bond. [visual]

As an overlay, we can calculate the internal rate of return of the 30 years of premium payments against the total cash value at the end of that period, and see that the IRR of premium to total cash value is 4.77 percent with a risk index of 2.09. Think about what we've done here! We somewhat *raised* the overall portfolio yield through the inclusion of par whole life in the fixed income segment while somewhat reducing the risk of that portfolio. And that's just with the cash value of the policy!

This is a simple (and simplistic) example of contextualizing the cash value of needed lifetime life insurance with portfolio returns *in the asset class most associated with par whole life cash values* : fixed returns of high investment grade bonds and mortgages. It's *simple* because we intentionally chose a fixed income subclass for which we don't generally have to worry about income taxes, so it maps nicely to tax-favored life insurance cash values. And we acknowledge that it's *simplistic* because it assumes a constant 4 percent return, which since 2008 is at best whimsical! But what we do know is that dividend scales, with a lag of two to five years, are responsive to rising and falling high-quality bond yields, and that in the long run dividends will mimic interest returns from conservative, intermediate term, fixed-income investments.

To complement our insurance-specific case example, let me briefly describe Thornburg Investment Management's December 31, 1979, to December 31, 2009, study of "real real returns." Imagine you had

invested \$100 in the S&P 500 on that first date and let it ride for 30 years. What do you think it would be worth? Many people are surprised at the answer—\$2,440 reflecting a nominal, geometric return of 11.24 percent over those 30 years. But wait, do we get to *keep* all of that? No! [visual]

We have to account for expenses and dividend taxes and capital gains taxes and the biggest tax of all, inflation. What you got to *keep* was \$459 and a more down-to-earth 5.21 percent real return. That doesn't diminish the value of investing in stocks; it just reminds us that it's not what we make but what we keep. If we look at some other key asset class returns in the same 30 years, we can see that in the fixed income category, 20-year US bonds had a real real return of 1.94 percent, and intermediate bonds had a 1.06 percent real real return. Guess where cash values came in for this time frame? A perfectly respectable 1.6 percent for this asset class in this time frame!

We should pause for a moment and consider some additional nuances of this conversation about Modern Portfolio Theory and asset diversification. Often a discussion of permanent life insurance is rebuffed with the throw-off line that “I can do better with my money in the stock market”—or in real estate or in dot-com or, once again, you fill in the blank! But we're not competing with that. Life insurance as an asset class recognizes that lifetime needs for life insurance can only be affordably met with policies that are actuarially and financially designed for that purpose. And this isn't necessarily an argument for a specific *type* of lifetime-designed life insurance. There are additional considerations that might steer us to so-called performance UL or variable or indexed UL or par whole life or, in some instances, guaranteed death benefits, but I will suggest that any underlying cash value should relate to the larger investment portfolio by mapping to the type and duration of asset classes underlying the insurance company's support of these various types of policies.

That brings me to another interesting consideration we had in our research: the extent to which a portfolio of somewhat uncorrelated life insurance policies might make sense in the same way that uncorrelated assets help a client achieve a certain return consistent with risk tolerance, while providing more stability through diversification in difficult markets.

And this is how we came up with the notion of “efficient choices.” It's especially useful to consider when the total amount of life insurance exceeds \$2 or \$3 million or perhaps \$5 million. In this discussion, we acknowledge that many who need life insurance are naturally drawn to “lowest premium” and guarantees for

life insurance. But what if death benefits are worth less over a long life expectancy? Should there be access to cash values and naturally occurring increases in death benefits? In fact, if MPT diversification makes sense, then shouldn't there be a mix of equities and fixed assets for the financial health and sustainability of the policies? Whatever your answer, these are largely incompatible objectives for any one kind of policy!

To figure this out, there are some important considerations I want to discuss with my clients. I want to know whether they look at life insurance as just another expenditure like car insurance or whether they consider the investment aspects. I'm not trying to impose my expertise on them; I just want to know. I have a client in San Francisco who owns a successful business, and she has life insurance on herself for the benefit of her family as the sole wage earner. There's also key person insurance on her in the business. When we were writing our magnum opus, I asked Carol how she thought of her personal insurance, and it was no surprise to me that she saw it as a necessary expense. The next day I interviewed the CFO of her business and asked the same question but got a different answer. Her CFO said, "Well, it's a required accounting entry on our balance sheet. I debit cash and I credit to life insurance cash values the increase in cash value and dividend each year, and it's starting to look pretty good!" In other words, it's an investment!

The next thing I want to understand is the client's consideration for access to cash value. For Carol and her personal insurance, not so much, but in truth, she doesn't realistically "get" what the cash value is all about. But her CFO does! "I've made use of that cash value several times and made sure to pay it back as soon as possible. Once it was a lifesaver for the business during a cash flow crunch!" Finally, I want to know the real consideration for what I call "naturally occurring increases in death benefit," the kind that's purchased by whole life dividends or an overfunded VUL's excess cash value shoving the death benefit above its initial level. And it's rare that clients says they're okay with a level death benefit, especially after I explain that at the historic 3 percent inflation rate in this country, a level and fixed \$1 million policy on a 45-year-old is worth a little less than \$500,000 by age 67 and less than \$250,000 at life expectancy! Age 100? Fuggedaboutit! It's worth less than 20 percent of the original death benefit!

So let's consider the major styles of life insurance and how we might customize a portfolio of policies to meet a client's particular considerations of price versus value, access to cash value, and naturally increasing death benefits.

As you can see from this chart, guaranteed death benefit policies are the clear *price* winner, and whole life is the “high-priced spread.” [visual] But when viewed through a time-value-of-money “value” calculation that considers premium and cash value *created* by the premium, those results reverse themselves. And while guaranteed death benefit policies are relatively cheap, they immediately start depreciating in real dollar death benefits while providing little or no access to cash value. And we even assess the inherent risk issues underlying policies, from little risk with a guaranteed death benefit policy issued by a Comdex 95 or higher carrier, to the conservative underpinnings of whole life, to the risk/reward opportunities in variable universal life.

You may notice that I haven’t considered the most popular new policy on the block these days, indexed UL. But if you assume that you’ll properly fund either an IUL or a VUL (not just try to buy it “on the cheap”) and that you’d keep it for the long-term, I’m going to simplify this exploration of efficient choices by isolating our styles to guaranteed death benefit, VUL, and whole life as representative of three distinctly different policy design styles. Again, I’m not disregarding IUL, but I want to show this concept to you with a manageable universe of options.

What we’ve done, and you’ll see more narrative explanation in the white paper, is to construct a matrix that addresses, in your generic consideration of risk tolerance, a focus on either price or value. [visual]

If we have a client who is in a mid-range risk tolerance seeking *best price*, the initial suggestion is to acquire equal proportions of guaranteed death benefits and variable universal. But if that same client with that same risk tolerance is more concerned about *value*, which incorporates access to cash value and an “investment” accounting mentality for that cash value, we get a very different suggestion: 60 percent par whole life, *no* guaranteed death benefits, and 40 percent VUL. [visual]

As an aside, I personally like the versatility of VUL, but I think it was oversold because it illustrated well, often meaning that premium dollar-for-death benefit, it illustrated an extremely low planned premium when using a 12 percent constant return assumption allowed by federal regulation. Of course, today’s insurance buyer, and perhaps agent, is a little gun-shy in today’s equity markets. I guess I’d say that having an all-VUL insurance portfolio is like buying “naked options”: lots of potential, lots of risk. On the other hand, covered options in the equity market give you more control over the risk you take, and I consider VUL with whole life in the efficient

choices realm of insurance portfolios, more like a covered option that can make sense to those with the experience, resources, and understanding of the pros and cons of such an approach.

Once again, while I typically don't consider life insurance as an investment, whether using a single policy or two or three different styles of appropriate policies combined into a life insurance portfolio, efficient choices demonstrates the lifetime value of treating and managing life insurance as any other investment. If the proportions initially deriving out of the matrix are not precisely the final recommendation, it is a great conversation starter and something the typical advisor has never seen from an "IN-surance" agent!

What I've just spoken about is not just theory; it actually works! Shortly after the publication of the first volume of *Life Insurance as an Asset Class*, I was referred by one of the national accounting firms to a privately held business that had just lost its shareholders in a freak accident, leaving a 29-year-old nephew as the sole owner of this \$1 billion manufacturing business. I was retained as the second opinion, although the CFO was quite insistent on applying his insurance prowess. He had proclaimed: "Everyone knows that guaranteed death benefit [UL] is the cheapest coverage, and since we need so much of it, that's what we're going to do."

I didn't have much time to get their attention away from price, so I quickly borrowed a concept from our recent publication. I posed the following scenario to the CFO, corporate legal counsel, young instant billionaire, and his legal counsel: "Imagine for a moment that you're the successor trustee owning this policy over all these years, and right on time Timothy dies at the ripe old age of 100. In a matter of 45 days or so, you're now holding a check for \$250,000,000. What's your first thought?"

Amid a lot of eye rolling, I saw that the CFO suddenly "got it" and he turned as pale as a ghost. Do you know what \$250,000,000 is worth roughly 72 years from now? Just one-tenth of the nominal amount in real dollars!

Now I had their attention! They listened to the concept of efficient choices and in fairly short order the broker (remember, I'm just the hired gun here) had started the underwriting on \$250,000,000 of life insurance, which ultimately morphed to \$300 million and was probably the largest amount written on one life that year. [visual]

By the way, it took a year to underwrite this total package and was placed with 17 different companies with an allocation of 30 percent whole life, 20 percent guaranteed death benefit, and 50 percent overfunded VUL. And

we were able to use our Monte Carlo to suggest an appropriate management process for all those policies over the next 72 years with the objective of getting as close to possible of an inflation-tracking real dollar value at age 100.

As you can imagine, this expanded context introduces some interesting opportunities to help clients with their existing policies, whether you sold them or not. Now I didn't say *replace* those policies; I said *help* with those policies! In our experience (we manage policies for ILIT trustees), most of the time UL policies can be remediated to better advantage than buying a new one with lower guarantees. But, of course, that's a facts and circumstances issue. Let me give you an example of our process.

In 1999 a client acquired a VUL with an expectation of paying \$8,800 a year for the \$1 million death benefit, and, of course, the illustration said that would work. The client eagerly asked, "How do I make out my check?" [visual]

Ten years later, through one tough stock market decline (2000–2002) and one *really* tough stock market decline (2007–2009), the policy remarkably was only \$4,000 off the originally projected, tenth year total account value. Apparently, the client had a hunch about the direction of the market in early 2008 and pulled his money into the money market option. So an account value of \$4,000 less than the original ten-year projection shouldn't be too much of a problem in the grand scheme of things and shouldn't have done too much damage. But we started out with an illustration—and resulting "premium"—that projected 12 percent forever as a constant return. Reasonably, *that* can't be the best measure of potential damage from downturned markets. In fact, when I applied a Monte Carlo assessment to the in-force policy, it projects *on average* to sustain the policy only to average life expectancy. [visual]

By the way, as an aside, and with what you know about life expectancy, do you expect to live less than, equal to, or more years than your peer group's life expectancy? In every group I ask that question, roughly 70 percent expect to outlive the average! So the possibility of outliving your policy is a real issue in this case. What can we do?

There are generally four remediation strategies we review with a client: (a) increase the funding premium, (b) decrease the death benefit (and/or eliminate a “Type B” increasing death benefit feature), (c) exchange to a different style, or (d) surrender or life settle. Let’s look at each of those in this case.

When I use our proprietary software and solve for a 90 percent confidence that the policy will sustain to age 100, I find that I have to almost double the funding premium to \$15,073. [visual]

(By the way, if you use my shortcut I spoke about earlier and if this were a 100 percent equity sub-account allocation, running an in-force illustration on the carrier’s illustration system at 7 percent should produce roughly the same recommendation for a new funding premium of this in-force VUL policy.) [visual]

Alternatively, we could find the death benefit that can be supported by the account value with no increase in original funding premium, and as a result lower the death benefit from \$1 million to \$650,000. Of course, there are questions of suitability to the original purpose for the life insurance, but it’s an option. Third, assuming that the insured is favorably insurable, we could exchange the VUL for a guaranteed death benefit policy and have a guaranteed, net annual outlay of \$10,530, substantially lower than the \$15,073 that we would have suggested to sustain the VUL. [visual]

And finally, we could surrender the policy for its \$60,500 account value (there wasn’t a more favorable life settlement value).

So what do you think? Have we covered all the possibilities with this approach? I’ll admit to you that we haven’t! See, there’s an embedded assumption I’ve been making, and that you probably make as well, about how long people are likely to live. We anecdotally know that people are living longer and that the fastest growing cohort is those age 100 or over, all 70,000 of them (out of a population of 310 million)! But the reality is that in any group of diverse ages, there’s only a 1 percent chance that any of you will live to age 100, much less past it. So let’s revisit life expectancy and see how some new tools may help us do a better job managing our client’s policies.

Here is a different way to image life expectancy from the “pyramid” I showed you earlier, but it’s accounting for the same thing: the number of deaths of a large, homogenous population over time until the last person has

died. [visual] The graph is tracking cumulative deaths from age 53 to age 114—“will the last person please turn out the lights?!” As with the pyramid, it’s easy to figure out average life expectancy; just draw a line on the vertical at the point where half the population is projected to have died, in this case at age 86.

We want a sense of how long someone is likely to live in order to help manage their universal life insurance policies. But is the 50/50 point a good measure? Seventy percent of respondents claim they expect to live longer than that point! Trustees, who are fiduciaries under most states’ laws, will typically play it safe and ask for the point where 75 to 85 percent of a population have died (at least statistically), but I think most of us would agree that age 114 would be assuming *too much* longevity to plan for. [visual]

How can we best use this information? Well, for a current assumption policy, it’s to measure how much to pay in planned premiums as we approach the client’s later years. [visual]

An 85 percent expectation might suggest an \$18,000 per year funding premium, where a 50/50 expectation would require only \$14,000. This isn’t especially rocket science, but we’re not seeing a lot of advisors—insurance-focused or otherwise—applying this approach to helping trustees and policy owners manage premium payments.

Where it gets more interesting is when there’s what I call a “health event” that’s likely to shorten the original statistical expectation for longevity. It might be a stroke or a heart attack or cancer. And with the technology introduced and continually being refined as to *personalized* life expectancies, first used for valuing life settlements and now more generally available for \$275 and current medical records, we’ve got some *very* interesting tools at our disposal!

As you can see on this chart, a health event has occurred at age 63 and an assessment of statistical life expectancy has moved the curve to the left; on average someone with this new medical profile is likely to die earlier than suggested by their “preferred” rate class underwriting of ten years earlier. [visual] The 50/50 LE is now age 80 as opposed to 86, and the 85/15 LE is now 92 rather than 98. And the potential funding requirements have shifted as well, a reduction of \$4,000 if measuring to 50/50 life expectancy and a reduction of \$3,200 if measuring to the 85/15 expectancy. It is also worth noting that personalized LEs are not just to

make UL insurance premium estimates; they can be useful to bring a more sophisticated approach to retirement income distribution planning, immediate annuities, and long-term care decisions.

One caution, however. We're talking statistical life expectancies; we're not predicting individual deaths. A few years ago a trustee engaged our services for an LE assessment on his parents with respect to their joint lives policy. She assessed at 137 months; that's 11.5 years for this 83-year-old. He assessed at just 33 months; he was already in a nursing home. Within the first year, however, she died. I use this example a lot because we have to make sure that people don't take false hope or despair from these projections. They're just numbers. And, in fact, we even suggest to trustees that they discourage the insureds from asking for the personalized LE information. It's not really about them; it's about the law of large numbers and a statistically based management process.

Before we finish with this topic of remediation, let's go back to the option of exchanging the VUL for a guaranteed death benefit policy. This option suggested the opportunity to reduce the remediation cost from roughly \$15,000 to about \$10,500, assuming favorable insurability. That seems like an easy decision, at least to clients and a lot of non-insurance advisors. But let's remember that there's a potential difference in the amount of death benefit of a well-funded VUL versus the absolutely guaranteed but level death benefit of the potential new policy. [visual]

What might you get for the \$4,500 difference if you choose to remediate the VUL? Well, for one, you get accessible cash value. Perhaps even more importantly, and with our Monte Carlo capability, I can tell you the average death benefit of the overfunded VUL at 50/50 life expectancy is going to be almost three times that of the guaranteed policy, with an inferred internal rate of return on the extra \$4,500 a year of about 10 percent! The average death benefit of the overfunded VUL at age 100 is almost six times that of the guaranteed policy, with a slightly lower implied internal rate of return on the extra \$4,500. Of course, in both cases you have to *live* to life expectancy or age 100 for these calculations to have any validity.

Since our theme today has been to deploy the language of financial planning in the conversation about life insurance, and in so doing differentiate and distinguish yourselves in your work with advisors and clients, let's talk about human nature and that Aristotle observation that "we're drawn to the attractive *impossibility* rather than the less attractive *probability* ." MDRT members are at the top of the mountain in the professional sale of

life insurance. So I'd be surprised if you haven't from time to time taken your significant insurance sophistication and projected that expertise into other financial areas, such as picking and buying stocks, perhaps investing in a friend's startup company, and maybe putting together a quick little partnership to explore distressed real estate. And I hope you did well! But I can virtually guarantee that if you *have* done any of these things, it's likely done without a blueprint or master plan that says, "Here's how we're going to methodically meet all our financial objectives without taking more risk than comfortable, regardless of how the economy is doing or the various markets are behaving." We often use the reference to the metaphor of a blueprint in the sale of life insurance, at least insofar as we explain to families how important it is to start with a proper foundation of appropriate insurance in the area of life, health, and disability—before working on the roof. But do you have a blueprint that guides you in making investments in those spontaneous tips or insights or "this is a great deal but we have to move on it *now* ?!"

The purpose of the blueprint, as I'll refer to it for the moment, is to avoid delving into incongruous, spontaneous investments involving, as it turns out, significantly more risk than was apparent at the outset. The idea is to have in place the planning process and more refined long-term strategies that can better articulate and differentiate investment implementation, in other words, to have a pre-agreed and thoughtfully laid out *process* for making decisions, even "on the fly."

In the investment world, the blueprint I've been referring to is called an Investment Management Statement, or IPS. Advisors in this area determine a new client's risk tolerance so that investment choices are given a context about risk and reward. After first assessing the client's current position and helping the client understand whatever inherent risk she or he is already taking, the planner will assemble several possible portfolios that reflect optimal asset allocation, addressing both tactical and strategic investing in the context of risk and reward. From there, the IPS is developed to guide in the current and future management of expectations and objectives in light of an uncertain future. Just as importantly, the process I've described can be used to monitor and manage the portfolio, with periodic reassessment of risk tolerance, asset allocation, and, in fact, the IPS itself. It's an ongoing process that lasts the client's lifetime.

When it comes to life insurance, I recommend that the very same approach be taken: Overall risk tolerance determined in the context of investing is used to make recommendations of a style or styles of life insurance as I've described today. This should conform to that tolerance or intolerance for risk, and these considerations,

plus the ones I'm about to discuss, form the basis of a written Life Insurance Property Management Statement, or LIPMS.

Using such a document in the consideration of "What kind of life insurance is in my best interest?" can then respond to the issues of an aggressive investor with respect to a portfolio of stocks and bonds and who might be less aggressive when it comes to a foundation asset such as life insurance. And that would be perfectly understandable. Another type of risk associated with certain policies (notably term and guaranteed death benefit), as I've described, is that such policies promise only the amount of death benefit specified in the original policy (if the policy is in force at the time of death), and the further out that death might occur, the more depreciated the purchasing power of that death benefit. If we measure the inflation rate in the 35-year period from January 1976 through December 2012 (which includes the hyperinflation of the late 1970s into the early 1980s), it will take almost four times the dollars 35 years from now to buy the same goods and services as today.

With the various risks accounted for in an assessment of insurance risk tolerance, a Life Insurance Policy Management Statement should be developed in the same manner, and with many of the same considerations, as the investor's Investment Policy Statement. The LIPMS should therefore address such issues as:

- Overall risk tolerance and its influence on policy choices
- Whether risk tolerance may be lower with respect to life insurance "because it's life insurance"
- Inflation risk (where death benefit is worth only half its original value after 24 years at 3 percent average inflation)
- Premiums as expense or asset creation
- Access to cash value
- Desirability of natural increases in death benefit
- Average return on portfolio assets by asset class and subclass
- Tax considerations of funding sources
- Annual gifts or premium resources existing outside the estate
- Acceptable carrier risk
- Acceptable policy sustainability risk
- Medical/avocation considerations

As you can see, the LIPMS has a number of elements. If you'd like to see my version—and you should consider customizing your own—you'll find a client questionnaire and a sample Life Insurance Policy Management Statement at appendices F and G in volume 2 of *Life Insurance as an Asset Class* .

Finally on this topic, while my “disciples” are now utilizing their own adaptations of the LIPMS, it's still *not* common. By introducing the concept to advisors and clients, you can imagine how to get a potentially antagonistic advisor to view you in a different light and appreciate how *you're* different.

As I move to my concluding remarks, I'd like to leave you with my version of “the seven habits of highly successful life insurance agents.” This is based on my observations as an insurance expert working with clients who seek my services because they're tired of being sold and replaced and otherwise having to deal with insurance agents who fulfill their worst fears of Ned, the annoying insurance agent in the movie *Groundhog Day* . Now I appreciate that none of you are like that, and you have your clients' interests as paramount in your relationship with them. But consider the following:

Habit #1: Facilitate the creation of a Life Insurance Policy Management Statement as I've just described.

Habit #2: Early on, address the client's inherent question “Do I *need* life insurance, and if so, how much?” Now that's pretty obvious as a key issue that we of course take up with our clients, but consider ways in which it's focused from the new language you've learned today: the language of financial planning. It could start out with “Mary and George, it would be helpful for me to have an understanding of *what's important to you* about having life insurance. What are the issues you think need to be addressed? What are your considerations about the financial integrity of a family in the aftermath of a premature death?” You may also want to consider moving from the classic Tom Wolff Capital Needs Analysis to the more sophisticated concept of human life value. *That* conversation might start out with “Mary, I know you've worked hard and recently become a partner in your law firm, and you've been able to make good money after all those years of law school and 2,500+ billing hours a year as a new associate. What do you think you're likely to earn in *total* in the future? Would it make sense that, as with wrongful death lawsuits, your economic *value* —especially to your family—should be considered as equal to those future earnings?”

Habit #3: Help your client consider the question “What *kind* of life insurance is in my best interest?” We’ve talked a lot about that today—how to map investment risk tolerance to a likely style of life insurance policy. I also like to use this graphic, which helps me practically contextualize the different focus, value versus price, and talk more objectively about the different styles and how—or whether—they’re typically appropriate for someone with the indicated risk tolerance and to once again highlight *value* versus *price* . [visual]

Habit #4: Logically discussed after reviewing the likely appropriate styles of life insurance is to answer the question “What’s it gonna cost?!” And we all know that’s not an easy question to answer, especially after reviewing some of the flexible premium issues we talked about today. Once again with the financial planning perspective, I might ask the leading question, “Would it bother you if you realized that the policy you picked on the basis of ‘best price’ turned out to have a fairly low likelihood that it would be in effect at the time of your death, especially if you live to or beyond an average life expectancy?” While it’s a huge part of our job to listen to our clients and help them make smart choices, they and their non-insurance advisors also often have a need for objective information. “In my experience, long-term *value* is created by considering your long-term objective and the implication for funding premiums, and not to be sidetracked by the appearance of today’s low price, which can blow up later on if high interest rates/high stock market returns don’t materialize the way we’d like.” And to help clients appreciate that even with fixed and guaranteed premium products, they, too, have to be managed, if for no other reason than from time to time to confirm that the “guarantee” is still intact. In my experience, too many in-force policies have *not* maintained their guarantees, often due to not paying a premium or needing to “borrow” a premium from any accessible cash values, or sometimes simply due to carrier error. We want to know about those things sooner, not later!

Habit #5: Objectively handle the question “From which insurance company should I buy my policy?” It goes without saying that we need to work with companies with strong financials. And most agents today place coverage with more than one carrier, and that’s probably a good thing. But too much of a good thing might go the other way. Obviously we can’t stay on top of *all* the products of *all* the companies, so we naturally focus on a handful of carriers and their products. In doing so, we can develop a strong relationship with middle and senior managers and understand the big issues surrounding us today, such as how extremely low new money interest rates will influence new product design as well as to explore likely pricing changes for older policies for which the carrier can increase expense factors. A strong agent/carrier relationship builds trust and translates to better service and perspective to the consumer.

Habit #6: A follow-up to “which insurance company” is likely to be “and from which insurance agent should I buy life insurance?” It should be obvious that anyone practicing these habits along with a consumer-focused business model should be the logical choice. The very act of taking the time to address the things I’ve talked about today, and to listen carefully and be attentive to the client’s responses, should make you stand out in a crowd and be the logical choice.

Habit #7: Finally, be in a position to know and reply responsively to the question “When is a replacement of an existing policy appropriate and when is it *not*?” There’s way too much replacement of policies in this industry. That, of course, is just my opinion, but ask yourself, If replacement represents 50 or 60 percent of the yearly “new” business each year, and if that were true, how long can that sustain the industry and serve our clients? It’s expensive to drop policies; it’s expensive to buy new ones. Does “new and improved” have the same meaning in life insurance as it does with cereal or detergent? A policy doesn’t necessarily need to be replaced just because it’s “old,” and, in fact, a 4 percent reserve policy may be valuable just for that relatively high rate compared to today’s 1 or 2 percent guarantees. I’ve heard some agents express a belief that a policy designed under the 2001 CSO is inherently better than one with the 1980 CSO as its basis. But CSO only has to do with a carrier’s reserving and does not necessarily adversely affect the value of the policy. In fact, for par whole life policies, an argument can be made for the *benefits* of an older CSO policy! And let’s look back 40 years and see the effective design cycle—and “life” cycle—of modern life insurance policies. For the first 250 years of the industry in the United States, your policy choices were pretty limited: basic whole life or basic yearly renewable term. Then there was the big paradigm shift to current assumption universal life in the late 1970s, along with the huge run-up of interest rates into the early 1980s. Within five years of its introduction, universal life had captured 40 percent of the market for new permanent life insurance (with each percentage point causing a comparable drop in whole life sales). As interest rates began to abate and people recovered from the 25 percent one-day drop in the stock market in October 1987, variable universal became the new darling and quickly racked up its own 40 percent market share of new permanent life insurance. With disappointments in earlier UL policies, along with carrier failures in the early 1990s, no-lapse policies began to gain traction by the mid- to late 1990s, but the low interest earnings environment and Actuarial Guideline 38 (AG 38) reserving requirements are today serving the death knell for low-priced guaranteed death benefit products. So now we have indexed UL to the rescue, until something better comes along or until there’s a black swan event that has an adverse affect on those policies and the issuing carriers. That’s not a prediction! It’s just an observation that

new product ideas come and new product ideas go. The question is, What's best for my client? And that takes more than just viewing an older policy as a replacement opportunity for the design du jour.

I leave this topic and end this presentation with one final observation. Doing the right thing is something that is *always* in our control. We might lose a prospect in a premium pricing contest; we might see a policy we previously sold replaced by another agent when we believed that the client was better off remediating the existing policy. But doing the right thing lets us sleep better at night. As Mark Twain, our most eloquent observer on the human condition, observed: "Always do right. This will gratify some people and astonish the rest!"