

A FRESH LOOK AT LIFE INSURANCE

A Separate Asset Class

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In times past, most attorneys and CPAs probably would not have recommended their clients take their life insurance policies out of the same drawer as their automobile/ homeowner's insurance policies and instead file them with their investments.

But today, clients and advisers are beginning to catch onto the fact that a portfolio of life insurance can serve as a Separate Asset Class....one that allows clients more financial flexibility and planning opportunities for themselves, their heirs and their charitable interests. And major international financial institutions are also part of this shift, as evidenced by the fact that these institutions are buying life insurance policies worth face amounts totaling billions of dollars. In line with this trend, more advisers work under the premise that:

- Life insurance policy portfolios should be reviewed on a systematic basis for many reasons, not the least of which is to understand whether clients have any financial arbitrages that may have developed within their portfolios.
- Life insurance policies belong in the client's investment drawer.
- Life insurance internal rates of return (IRR) on death benefits are competitive with bond portfolios and sometimes equity portfolios over the long term.
- The major international financial institutions buying life insurance policies in the settlement market have discovered the value in life insurance as a Separate Asset Class uncorrelated with any other investments.

So, it's time to take a new look at the traditional life insurance policy and what it can mean for clients.

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A Case Study

The facts are that many wealthy families “buy” life insurance even though they don’t need it. Think about this client: An individual whose family is worth \$400 million, including \$60 million in toys (i.e., homes, cars, boats, etc.) and \$340 million in liquid investments (i.e., munis, corporates and stocks) clearly doesn’t “need” life insurance. They had more than enough liquidity to pay estate taxes, leave money to charity and still have plenty for the family. But interestingly enough, when this client saw the flexibility of the 21st century life insurance instrument, he and his spouse purchased \$80 million of new life insurance.

And believe it or not, this client was an individual in the investment business and considered by many to be an astute investor – a really smart guy – not much different than many other clients: smart people with a good understanding of their families’ values, businesses and investments.

So what has really changed in the life insurance arena to compel someone like this investment guru to “lose his mind” and buy life insurance?

The answer is quite simple: *He thought it was an investment that might do as well, if not better, than the investments he was already making.* Ultimately, he wanted to put more on his family’s “pile” – for his children, his grandchildren and charities.

He recognized:

- The IRR at life expectancy, and even after life expectancy, was nicely competitive with some of the other investments he held and the yields he expected they would return.
- Life insurance, when thought of as an investment, was not correlated with any of the other investments he would ever have.
- The death benefit gains were income-tax free, thereby enhancing the after- tax yields.

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- The insurance would not be subject to estate or gift taxes due to a structure jointly created with his insurance, legal and tax advisers.
- Taking a portion of his investment portfolio and putting it into life insurance was a piece of investment diversification that could allow his net worth to increase for the benefit of himself, his family and his charities.

Here are some reasons why life insurance has evolved into a piece of investment diversification – that is, a product worthy of being described as a “Separate Investment Class.”

Product Evolution

Let’s face it: The terminology used within the industry is a language unto itself; and a real test of understanding insurance vocabulary is to read a life insurance contract. Here are some of the industry terms frequently used: cash values, general accounts, separate accounts, variable, paid up additions, universal, increasing death benefit, over-funding, GDB (Guaranteed Death Benefit), life settlements and whole life.

Fortunately, technology has not only improved many things in everyday life, but in the world of life insurance, too.

Technology has allowed the industry to create products that are easier to communicate and more easily understood by clients and advisers, despite the inherent language barriers. Today’s products are much more transparent than yesterday in part due to technology. This new transparency along with competitive forces in the marketplace has demanded more cost-efficient products. These new efficiency created greater IRRs for consumers.

Today, life insurance products can be purchased “in sync” with a client’s strategic investment goals. If the client is more comfortable with guarantees and guaranteed rates of return, life insurance products exist to fit perfectly with this client’s objectives. On the other hand, if the client is comfortable investing in equities and taking more risk than guaranteed products, variable products are available for this particular

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individual. As with the purchase of any financial product, before investing policy owners should carefully consider the investment objectives, risks and charges relating to the policies under consideration as well as the investment options available in the variable products.

Marketplace Evolution

Major financial institutions are lending billions of dollars to buyers of life insurance to finance life insurance premiums. This has created a new level of credibility to the concept of life insurance as a separate asset class. With life settlements coming of age in the past five years life insurance can become more valuable as a living benefit as people get older. One doesn't necessarily need to die to win. As they grow older, many life insurance owners will have policies that have a market value greater than the cash values in the policies. This additional value offers them the opportunity for financial arbitrages.

Life settlements may be appropriate as client circumstances change and plans need to be adjusted. Just the knowledge that life settlements may offer future planning flexibility gives "additional legs" to the life insurance product in the financial marketplace not available in the past. The purchase of billions of dollars of inforce life insurance policies by major financial institutions worldwide gives even more credibility to life insurance being a separate asset class. Make no mistake about it...Life settlements may be beneficial for consumers of life insurance.

Experience shows that when clients understand life insurance and the unique way it can be structured to achieve family, business and charitable goals, they begin to see life insurance as a "Separate Asset Class" they can use to "make money."

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Exhibit A

			IRRs Assuming \$10,000,000 Level Benefit Paid at Death					
Issue Age	Life Expectancy	Annual Premium	5 Years Prior to LE		At LE		5 Years After LE	
			IRR	Pre-Tax Equivalent	IRR	Pre-Tax Equivalent	IRR	Pre-Tax Equivalent
Male Age 60	Age 86	\$140,754	10.07%	12.59%	6.79%	8.49%	4.76%	5.95%
Female Age 60	Age 88	\$111,924	10.15%	12.68%	7.20%	8.99%	5.30%	6.63%
Male Age 70	Age 88	\$269,121	14.20%	17.76%	7.20%	9.00%	3.81%	4.77%
Female Age 70	Age 90	\$196,817	14.18%	17.73%	8.23%	10.29%	5.09%	6.37%
Joint Lives Both Age 70	Joint LE - Age 94	\$149,787	11.47%	14.34%	7.48%	9.35%	5.12%	6.39%

*See full disclosure.

The following are some of the unique qualities of life insurance.

Tax and Financial Leverage

- Death benefits are income-tax free... up to a 40% +/- tax advantage
- Death benefits held in Irrevocable Life Insurance Trusts (ILITs) and other entities outside the insured's estate can be estate tax free for the insured's heirs... up to a 45% advantage.
- In most cases, premiums can be paid by ILITs without gift taxes needing to be paid by the grantor/insured... up to a 45% advantage.
- Pre-tax and after-tax IRRs at death, prior to life expectancy, at life expectancy and beyond life expectancy, are very attractive to many sophisticated buyers. (See Exhibit A.)

Planning Flexibility

- One beautiful thing about many trusts is they can be created in a manner offering asset protection for the grantor of the trust and the beneficiaries. Thus, when life insurance is held in a trust, death benefits can provide clients' families with creditor and divorce protection. With over 50 percent of all marriages ending in divorce, along with other types of litigation potentially surrounding clients, this is a unique strategic benefit.

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- It takes more than money to buy life insurance. It takes good health, as well, so “stockpiling insurability” can make a lot of sense and in some cases, “make” a lot of money for people as they get older. People who look at life insurance as an “asset class” can diversify with various types of life insurance, accumulating a portfolio of policies – that is, a combination of permanent coverage along with convertible term insurance, creating many favorable options.
- Americans continue to be the most charitable people in the world. Clients are no exception. Many wealthy families and “Millionaires Next Door” see life insurance as instrumental in their charitable planning.
- Financed life insurance, purchased within the confines of well-thought-out strategic plans and with workable exit strategies, makes a great deal of sense for clients who wish to make money for future generations of their families.
- A greater recognition exists among clients and advisers that life insurance is no different than most other investments. It must be reviewed and evaluated periodically and adjusted when necessary. Life insurance is a “contact sport,” and both clients and the adviser team must be “in the game”.
- The good news for people who do “need” life insurance protection is the reality that life insurance provides asset diversification for them, as well. They benefit from all the advantages as those received by people who don’t “need” it but want to “have it.” Some of these clients may become people who “don’t need it” at some point in the future but see and understand the true value of life insurance earlier on.
- Clients who do not “need” life insurance today, but who take the time to understand the life insurance product, are different than past generations of clients. They become participants in the process, fully engaged and appreciative of how important this asset is for themselves, their families and charities. They pay attention to their insurance portfolio similar to the way they watch their investment portfolio because they see it as another important asset that can “make money” for them and their families. In that regard, it is fun for most of them.

Imagine that – life insurance being fun! What a novel approach to the conventional viewpoint.

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**It's best not to over-play or under-play the positive Internal Rates of Return (IRR) at death of life insurance. Clearly, when someone dies prior to life expectancy, the IRR at death is generally anywhere from "attractive" to "astounding." At life expectancy (LE), when there is a 50 percent probability an insured won't make it that far, life insurance can still provide a handsome result. If the insured dies five years later, a 75 percent statistical probability, the IRRs can still be attractive – similar to that of historical long-term bond yields. The added benefit is that life insurance proceeds are not income-taxable. And while not shown, the estate tax-free benefits available through the purchase of life insurance in trust further enhances the argument. Illustrated below are hypothetical IRRs for a guaranteed death benefit policy based on a preferred risk, non-smokers risk class from a major life insurance company.*

Pre Tax Equivalent assumes a 20% tax rate to reflect a hypothetical blend of capital gains and ordinary income tax brackets.

Based on 2001 Valuation Basic Table, Select & Ultimate. Life Expectancy tables are based on actual mortality experience collected from sources such as life insurance companies and the Social Security Administration. The LE shown is approximately the age at which there is a 50-percent probability the insured will have died by that age. In the case of the Joint Life Expectancy there is a 50-percent probability that at least one of the insureds will have survived by that age. The LEs represented are not specifically tailored but are based on population averages and are presented to help you form a generalized idea of potential ages at death. The data shown is taken from an insurance company-provided illustration and assumes a hypothetical rate of return and is not a representation of expected future results.



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