Ruminations on Permanent Life Insurance

Financial advisors disagree vehemently about three topics: fees vs. commissions, active vs. passive management, and the subject of this article: permanent life insurance vs. taxable investments.

Assumptions & Observations

First, a few general comments before I discuss the specific factors impacting this decision:

1) While both investment and insurance vehicles may have poor performance, excessive costs, etc., I see no reason to assume one to have consistently superior gross performance over the other. Too often the best products from one type are compared to the worst products of the other type biasing the outcome. A fair comparison would be a very good, inexpensive life insurance policy versus a very good, inexpensive investment vehicle.

2) Many people act as though they consider insurance proceeds to be free money. There is no printing press creating money in the insurance company's basement. In the long run, premiums are merely returned to the policyholders (unequally however) less a haircut for administrative expenses, commissions, profits, etc. Remember the most fundamental general rule is TANSTAAFL (There Ain't So Such Thing As A Free Lunch). There are two possible exceptions to this with life insurance: 1) If you die prematurely, (earlier than the actuaries predicted) you "win." Of course, this benefit is offset by the reverse, if you live longer than expected, you lose. 2) There may be tax advantages from the insurance that make it superior.

3) Estate taxes are frequently presented as the rationale for purchasing life insurance. To the extent the insurance is out of the estate (in an ILIT for example), the annual gifting could be made in cash to the beneficiaries directly. The beneficiaries could then do this same analysis (taxable investment vs. insurance) to decide whether they should invest the gift (or any other funds for that matter) in an insurance vehicle. While it is true that funds may be needed for liquidity at death, the gifts could be invested in a taxable account to accumulate that liquidity. This brings us back to the "die early and win" versus the "die late and lose" issue mentioned previously. If estate liquidity is needed in the short run, term insurance can be purchased and taxable investments used to accumulate the liquidity for the long run.

Factors

This brings us to the specific factors that impact this decision. All of these don't have to be true to make buying a permanent policy advisable, but the more that are true and the greater the extent to which they are true the more a permanent policy would be advantageous.

1) Mortality – Because most people have superannuation risk (the risk of lasting longer than your portfolio), compounding this risk would be irrational. Considering that insurance purchases are good if you die prematurely and suboptimal if you live a long time, purchasing permanent insurance as an investment (as opposed to for income replacement or other risk reduction) is generally irrational. Thus, in regard to this factor, it would seem that **permanent insurance should only be purchased by those with little or no risk of outliving their resources**.

2) Income Taxes – Higher tax brackets favor the life insurance policy unless the policy is lapsed. Then, the detrimental treatment of gains being taxed as ordinary income rather than capital gains tends to make the taxable investment more favored. Additionally, using insurance removes the

option of tax loss harvesting. Note also that while insurance proceeds are income tax free so are capital gains if the investment is held until death for the step up in basis. While no taxable investment is perfectly tax efficient, equity index funds or ETFs would be very close. If the investments in question are very tax inefficient (REITs, HY Bonds, other fixed income particularly in an inflationary environment) or have very high turnover, some sort of insurance wrapper (such as an annuity) may be appropriate if there are not enough assets in an IRA or similar vehicle to shelter those assets from current taxation. In addition, there is a risk that the tax code changes in the future causing the death benefit to be income taxable. Thus, **permanent insurance should only be purchased if there is a) a high degree of confidence that death benefits will continue to be income-tax-free in the future, b) tax-advantaged vehicles, such as a 401(k), deductible IRA, Roth, etc., have been fully utilized, and c) tax inefficient investments would otherwise be held in taxable accounts because retirement accounts are not large enough.**

3) Flexibility – Taxable accounts obviously have almost unlimited investment choices as well as the advantage of being able to cash out completely at any time without cost (other than taxes). Cashing out insurance policies in the early years frequently incurs very large losses as many expenses are front-loaded. This can be thought of us the equivalent of an enormous contingent deferred sales charge (back-end load) that lasts, in many cases, for decades. Also, cashing out in later years will incur ordinary income taxes rather than capital gains as mentioned previously. Thus, **permanent insurance should only be purchased if there is almost no chance an unforeseen contingency will cause the funds to be needed during the insured's life.**

4) Insurance need – Life insurance is more favorable to the extent that it is needed anyway for risk reduction. Thus, **permanent insurance is more advantageous when a term policy would otherwise be purchased anyway.**

5) Bad M&E effects – This is a little complicated. Essentially, in a variable permanent insurance contract, there are two components of the death benefit from the insurance company's perspective: 1) The cash value of the policy and 2) the difference between the cash value and the death benefit – known as the "amount at risk." Each year, a Mortality and Expense charge (M&E) covers this second amount. Essentially, the account is charged for one year term insurance. This has pernicious effects. If investment performance is good, the amount at risk decreases reducing the M&E charge and making the policy perform even better. Conversely, if the investment performance is bad, risk increases, the M&E charge is higher, and the policy performs badly. Thus, good results get better, and poor results get worse in the investment portion of the insurance. Thus, **permanent insurance policies must be monitored regularly and fully funded.**

Conclusion

The purpose of financial planning is to maximize your happiness across multiple contingencies. The worst-case scenario or "perfect storm" for most people is living a long time and receiving poor investment returns simultaneously. In this case, you may have to fund the insurance more than you want to (or can afford to), or if it is lapsed or cashed out, there may be taxes due at a higher rate (ordinary income vs. capital gains). In that case, permanent insurance will be much worse than a taxable investment. Conversely, in the event of premature death and/or very high investment returns, the insurance vehicle may well prove superior. Making good outcomes better at the cost of making bad outcomes worse is generally not the correct approach because people are typically risk averse rather than risk seeking.

Notes:

The analysis in this report has been prepared by David E. Hultstrom, MBA, CFP©, CFA©.

*Mr. Hultstrom is the president of Financial Architects, LLC, a financial planning and wealth management firm. Questions or comments are welcome, and he may be reached at David@FinancialArchitectsLLC.com or **(770) 517-8160**.*

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