What Life (Insurance) is Really All About

CEPC

September 16, 2009

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“Needing life insurance is like needing a parachute. If it isn't there the first time you need it, you won't be needing it again.” ::anonymous

Never mind your 401(k). How’s Your Insurance?

- “insurance is the least sexy asset in most portfolios. If it were an appliance in a remodeled kitchen, it would be the garbage disposal---useful, hidden, and nothing to show off like that stainless-steel range.”

Paul Sullivan, *New York Times* 4-18-2009

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The current climate

- Investment losses in the past year have been a wake-up call
  - ✓ Many people have realized they shouldn’t have given away so much
  - ✓ Many people have realized they don’t have enough for themselves
  - ✓ Many people have realized that boring assets like the cash value of life insurance can come in pretty handy

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Everyone’s an expert…

- The compulsion to opine…
- “is that your personal opinion or your professional opinion?”
- ..and then there are the financial entertainers (or financial pornographers, depending on your point of view)

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The Need for Expanded Knowledge

- Estate planners seem to spend most of their efforts on clever ways to get insurance out of a person's estate
- Perhaps more education is needed on the value of life insurance as an asset
- Life insurance is valuable property, not bitter medicine
- Maybe it is such good property, that it would be good to keep it IN the estate

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Getting Financial Advice from TV personalities and newspaper columnists is like getting your news from Comedy Central

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..so a guy goes to his Banker…

- Property available for $280,000
- I want bank to buy it back from me for $1 million when I'm 65 (35 years)
- I want the bank to promise that it will grow proportionately to that value every year
- I want the bank to absorb any income taxes payable on the yearly gains
- I want the bank to absorb maintenance costs and any taxes during the years I am the owner

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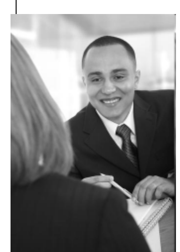
A proposition for Your Banker
In addition…



- If I die, the bank will pay my heirs the $1 million, even if this happens tomorrow, or next month, or in 10 years…
- I want the bank to be trustee and administer sale proceeds for my heirs or me, with a guarantee of principal & interest

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A proposition for Your Banker
Further Terms…

- I want to have the privilege of buying the property on installments over 20 years—paying, say, $22,000 yearly
- If I die before paying in all of the installments, I want the bank to cancel the remaining payments, with full value still delivered to my heirs.
- I want the property to be protected from the claims of creditors and any lawsuits.

A proposition for Your Banker

- If the bank accepts these conditions, I will go ahead with the transaction..
- What do you think?

State of the Industry

- Shrinkage in professional sales force
- Increase in "amateur" sales force
- Decreased training
- Increased churning
- Decrease in "new, creative" sales
- Serial attacks on traditional whole life by universal life, then variable universal life, now equity-indexed universal life and secondary-guarantee UL

Lanny's
History of Life Insurance
1971-2009

In the beginning…

- There was participating Whole Life
- There was non-participating Whole Life
- There was term insurance
- There were a lot of large mutual life insurance companies with thousands of "captive" agents selling their products

The Serial Attack on Whole Life

- High short-term interest rates spawned Universal life in late 1970s-early 1980s
- UL projected double-digit interest rates into the hereafter
- Huge blocs of whole life insurance were replaced by UL that would supposedly outperform a stodgy out-dated product
- Some clients were told that the cash value in their WL would be enough to fund the new UL with little, if any additional premium
- Others were told they could pay much lower premiums because UL paid them higher interest
- Most agents sold it and walked away…

The Serial Attack on Whole Life

- Whole Life (including existing policies) was updated to be competitive
- Interest rates dropped like a stone
- Policies underperformed projections
- "Paid up" policies became "not-so-paid up"
- Low premiums became insufficient to provide coverage permanently…BUT
- Hardly anyone paid attention for awhile
- Then they did!

The Serial Attack on Whole Life

- **The UL party was over, so companies moved on to "the next big thing"**
- **The next thing was VARIABLE UL ("VUL")– because equities were HOT**
- **VUL could be presented at any assumed interest rate from zero to 12%**
- **The party was on again**
- **More WL was replaced, along with lots of underperforming UL—for the same reasons, using the same strategies as before**

The Serial Attack on Whole Life

- No VUL ever performed as illustrated, because the market is not linear
- Equities did well till the tech bubble burst, the terrorists attacked New York, and the real estate bubble burst
- So VUL policies failed to perform as originally projected, just like UL
- Whole Life experienced "re-birth"

New Players…

- Enter Universal Life with a Secondary Guarantee
  - ✓ policy guaranteed to last even if cash value plummets to zero, as long as premium is paid consistently and no money is withdrawn or borrowed
  - ✓ No more concerns about policy performance (only company stability and survival) as long as you never skip a beat
  - ✓ For some, it is the "Holy Grail"---permanent term insurance

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New waves of replacement

- Guaranteed paid up policies
- Concept: Avoid sleepless nights for trustees
- "We don't need no stinkin' cash value…"

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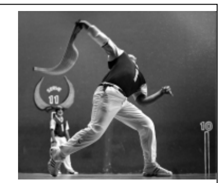
New Players…



- Enter Equity-Indexed UL ("EIUL" or "IUL")
  - ✓ Interest crediting based on performance of equity-index (like S&P)
  - ✓ Insurance company selects the interest rate, based on its selection of performance-period for the index
  - ✓ EIUL is sold exactly like UL and VUL; higher rates, lower premiums or quicker-pay scenarios
  - ✓ No SEC/FINRA supervision
  - ✓ Securities Regulation closing in

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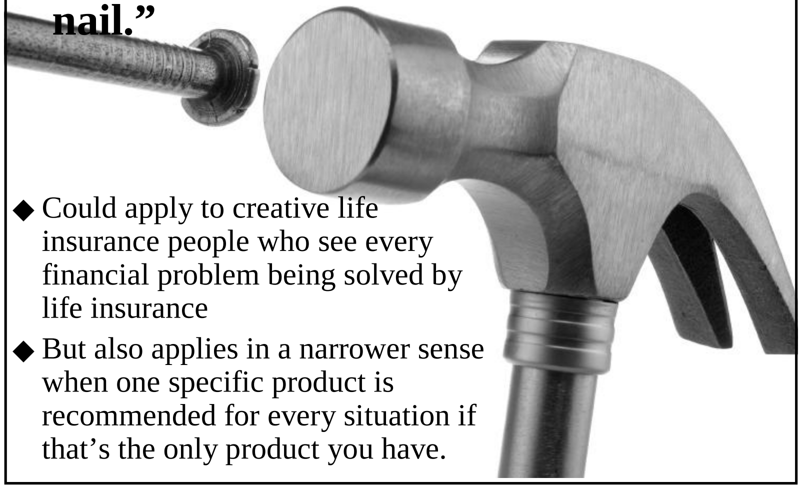
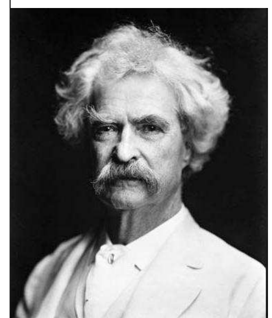
“When your only tool is a hammer, everything looks like a nail.”



- ◆ Could apply to creative life insurance people who see every financial problem being solved by life insurance
- ◆ But also applies in a narrower sense when one specific product is recommended for every situation if that’s the only product you have.



“It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.”
---Mark Twain

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If I pay my life insurance premium as billed, I don’t have to worry about my life insurance coverage.

- ◆ This depends on the type of plan
  - ✓Term insurance—yes
  - ✓Whole Life-Yes
  - ✓Universal Life-NO[1]
  - ✓Variable Life-NO[2]
  - ✓Equity-indexed UL-NO[3]

[1,2,3] Unless “secondary guarantee” included, and no loans or withdrawals

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…but when I bought this policy I was told it would be paid up in 10 years…

- ◆ Most “quick-pay” expectations are based on non-guaranteed elements of a policy
- ◆ Predicated on linear extrapolations of current[1] or hypothetical[2] interest, mortality and expense factors

[1]whole life, universal life [2]variable life, equity-indexed UL

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This proposal looks good all the way to my life expectancy, so I am "golden."

- ◆Life Expectancy is **not** the age when you are "expected to die"
- ◆Life Expectancy is a MEDIAN, which means that HALF of the people your age are expected to LIVE.
- ◆Make sure the policy will be good until you are really dead

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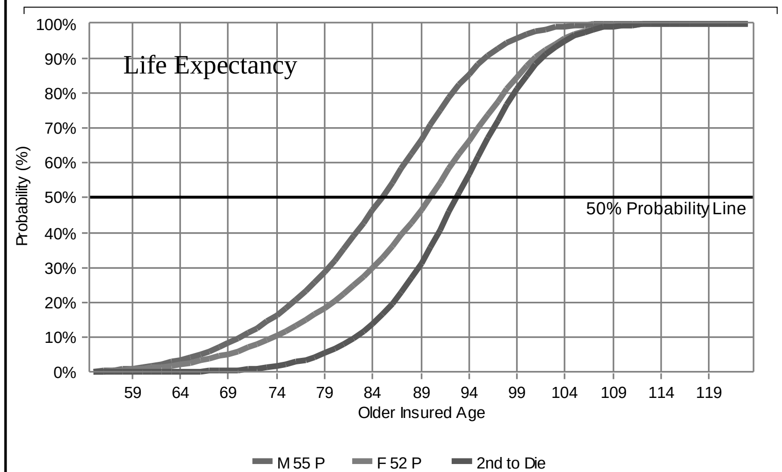

- ◆ Male 55 & Female 52 both Pref Non Tobacco

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Let's look at one company's current mortality table

- ◆ Male, 55, Preferred Non Tobacco
  - ✓50% likelihood he is alive at 85
  - ✓25% likelihood he is alive at 90
- ◆ Female, 52, Preferred Non Tobacco
  - ✓50% likelihood she is alive at 87
  - ✓25% likelihood she is alive at 93
- ◆ Joint Lives (both considered together)
  - ✓50% likelihood one is alive at 90
  - ✓25% likelihood one is alive at 94 (younger)

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Life insurance should always be purchased based on need.

- ◆Life insurance is insurance to replace an income-producing asset (see Huebner)
- ◆No other insurance is purchased based on "need"
- ◆Insurance is purchased based on the value of an asset that might be destroyed
- ◆Ideally, life insurance is properly purchased in an amount equal to a person's human life value

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Human Life Values

- "…the capitalized monetary worth of the earning capacity resulting from the economic forces that are incorporated within our being: namely our character and health, our education, training and experience, our personality and industry, our creative power and our driving force to realize the economic images of the mind. "
- "It is the cause (the creator) of all other values and not merely an effect. Were it not for the life value, there would be no property values at all."

:::*The Economics of Life Insurance*

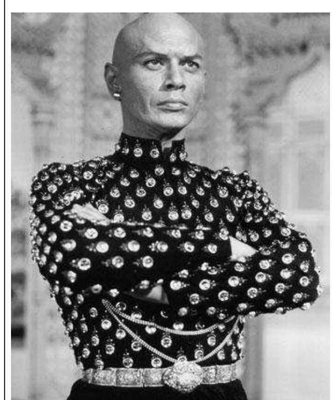
Human Life Value

- **Focused on the economic value of a life's work**
- **"HLV" calculates present value of that economic value**
- **Similar to "damages" calculation in wrongful death / "9/11" settlements**
- **Does not reflect current assets, existing life insurance, or spouse's earning power**

You won't need life insurance for more than 20 or 30 years

- Typical statement made by financial columnists and pundits who recommend buying term insurance
- "In 20 (or 30 years at most), your mortgage will be paid off, you'll be out of debt, your children will be grown, out of school and independent, and you will have grown your own estate sufficiently to dispense with life insurance."

You won't need life insurance for more than 20 or 30 years



- To quote the King of Siam
- "…that is a false lie!"
- There will never be a time when you are better off without it.

Reasons You Might Want Life Insurance for More than 25 or 30 years

- Just like there are three important factors in real estate, permanent life insurance offers there are six important factors in a financial plan:

1. Flexibility & Control
2. Flexibility & Control
3. Flexibility & Control

Reasons You Might Want Life Insurance for More than 25 or 30 years

- Because….
  …it never ends….

You Might Want Life Insurance > 25 or 30 years Unforeseeable Family Situations

- You want ongoing protection for a disabled child…
- You have a not-so-prosperous adult child
- You want to provide for your grandchildren
- Your adult child may become a single parent dependent on you…
- You have children later in life
- You or a family member suffer a financially crippling lawsuit that drains your assets
- Your children go beyond the educational level you anticipate right now
- Your child wants to pursue his or her passion…

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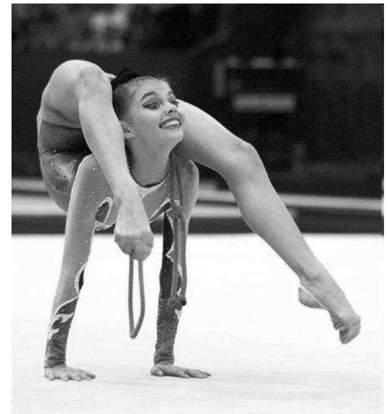
You Might Want Life Insurance > 25 or 30 years Current obligations replaced by new obligations

- ◆ You sell your current home/purchase of a larger home with new mortgage extending into your retirement
- ◆ You purchase a *second* home with new debt
- ◆ You start a business and take on debt to fund its startup…
- ◆ You expand your business, using debt to fund the expansion…
- ◆ You buy out a business partner incurring a financial obligation that might outlive you…
- ◆ More expensive toys…
- ◆ Unforeseen health care costs drain your assets

You Might Want Life Insurance > 25 or 30 years You Want Retirement Flexibility



- ◆ See next item of misinformed wisdom…

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You won't need life insurance once you retire.

- ◆ You may or may not "need" it, but you are very likely to WANT it.

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Life insurance is only necessary until you've grown your own estate.

1. If human life value exists, the size of your estate is irrelevant
2. When human life value has diminished (i.e. at retirement), life insurance will enhance distribution planning.

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Life insurance enhances your retirement plans with flexibility

- A portion of your investment program “tanks” and you don’t have some of the assets you anticipated
- You might want to elect the maximum pension benefit under your retirement plan—the option that ceases at your death…
- You might want to “spend down” all of your assets and still leave an inheritance for your children…
- You might want to have guaranteed collateral so you can borrow money for retirement income
- You might want to transact a reverse mortgage and payoff the accumulated debt after your death

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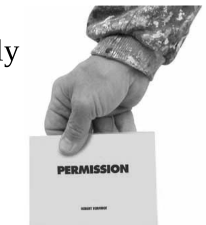
Life insurance enhances your retirement plans with flexibility

- Assets+life insurance > More assets + no life insurance
- Life Insurance allows you to take LESS risk with your other assets
- Life Insurance can allow you to take MORE risk with your other assets
- Life Insurance can permit you to stay fully invested and not pull money out of other investments at the wrong time
- Life Insurance grants you “the power to consume”



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The ave. mutual fund investor earned c. 12% over the past 20 years.

- DALBAR conducts an annual Quantitative Analysis of Investor Behavior (“QAIB”).
- QAIB studies actual mutual fund investor results
- “Investment return is far more dependent on investor behavior than on fund performance.”
- 2008 QAIB showed that average investor earned 4.48% annualized return over 20 years ending 12/31/07, about 700 basis points less than the S&P
  - ✓ Real people panic and sell when their assets have dropped
  - ✓ Real people don’t buy until an asset has risen significantly

DALBAR The Measurement of Success

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Life insurance is a poor investment.

- The nation’s largest banks own permanent life insurance as a key element of their Tier One capital (some as much as 30% or more)
- Fortune 500 companies have bought COLI in huge quantities
- Investors want it even without tax-free death benefits
- Hedge Funds have been bribing people to take out insurance so the investors can obtain policies without insurable interest limits

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Wall Street Pursues Profit in Bundles of Life Insurance

- ◆NY Times, September 6, 2009
- ◆Bankers plan to buy life settlements and securitize them into bonds
- ◆Life insurance doesn't correlate to other asset classes

The New York Times
nytimes.com

Life insurance is a poor investment.

- ◆ Compared to what? Stocks? Real Estate?
- ◆ Can anyone still make this statement after what we've been through in the past 10 years?
- ◆ *Life insurance was never meant to compete with equities or real estate*
- ◆ Life insurance belongs in the *defensive* asset class of bank accounts, CDs, money market funds and bonds---safer, lower volatility assets
- ◆ When configured properly, it performs well compared to these PLUS has unique advantages

The Mathematics of Volatility

- ◆How does boring life insurance stack up against exciting more volatile returns?

Life insurance is (at least) a Triple-Duty Asset

1. Insurance protection providing a permanent legacy
2. Conservative tax-deferred investment earning a respectable return
3. Protection from judgment creditors in many states (unlimited in Illinois if beneficiary is spouse or children)

…Maybe Quintuple Duty…

4. Disability benefit---via the waiver of premium rider
   - ✓ pays the premium
   - ✓ delivers self-completing asset accumulation
   - ✓ is available even if you have maxed out your disability insurance benefits)
5. Funding terminal or chronic illness expenses
   - ✓ Accelerated benefit provision
   - ✓ Provides access to money beyond the loan value

Pay as little as you can for life insurance.

- ◆ Buy the house that has the lowest price?
- ◆ Buy the business that costs the least?
- ◆ Buy the car the has the lowest price?

Why do I have to borrow my own money from my life insurance?

"Paying interest on my own money is a rip-off"

- ◆ You aren't borrowing "your own money"
- ◆ You are borrowing from the life insurance company, using your policy cash value as collateral
- ◆ You are free to pledge this asset as collateral for a loan from any source you choose if you can get a better deal

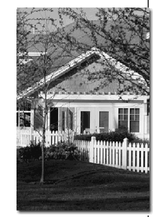
Why do I have to borrow my own money from my life insurance?

- ◆ Say you own a home and you owe less than the market value of the home.
- ◆ For example your home is worth $800,000 and you owe $500,000.
- ◆ (Yes, Virginia, there is such a thing as equity.)
- ◆ Your equity is $300,000 in this example.
- ◆ You borrow $100,000 from a bank with your home as security. You are charged a market rate of interest.
- ◆ Are you borrowing your own money? NO; you are borrowing from the bank, with your home equity as collateral.

I shouldn’t have to pay interest on my own money from my life insurance.

- ◆ You borrow $100,000 from Guardian, with your policy cash value as security.
- ◆ You are charged interest
- ◆ Are you borrowing your cash value?
- ◆ NO; you are borrowing from Guardian, and Guardian is willing to do so because your CV is pledged as collateral.

I shouldn’t have to pay interest on my own money from my life insurance.



- ◆ In the home example, your equity continues to grow based on your subsequent payments on your mortgage (i.e. debt reduction) and the increases in FMV of the home (you hope).
- ◆ In the life insurance example, your guaranteed cash value continues to grow (promised by contract), just as if you hadn't taken the policy loan, and you continue to receive dividends.

3 related myths

1. The main purpose of life insurance after retirement is to pay estate taxes
   corollary: if you don’t have tax problem, why keep life insurance?
2. If you have a taxable-size estate, you should own your life insurance in an ILIT.
3. If you’re married and you expect to have a potential estate tax liability, you should buy 2nd - to-Die Secondary Guaranteed Universal Life insurance in an ILIT

Let’s review these one at a time

The main purpose of life insurance after retirement age is pay estate taxes

- ◆ Adjustment or equalization of legacies, especially for business owners
  - ✓ Second spouses
  - ✓ Children not active in family business
  - ✓ Use your imagination
- ◆ Charity-life insurance will replace charitable gifts or can BE the gift
- ◆ More flexibility in enjoyment of retirement assets
  - ✓ Pension/annuity maximization
  - ✓ Pay downs assets, not just live off interest
  - ✓ Leveraging of assets

If you have a taxable-size estate, you should own your life insurance in an ILIT.

- ◆What about flexibility and control?
- ◆What about the age of the client?
- ◆What about the significance of the policy cash value to client plans?
- ◆What about other assets that might be higher growth in the next xx years?
- ◆Don’t be so quick to lock it up

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If you’re married and you expect to have a potential estate tax liability, you should buy 2nd -to-Die Secondary Guaranteed Universal Life insurance in an ILIT

- ◆ Consider age of clients
- ◆ Is there really going to be an estate tax liability at or beyond life expectancy?
- ◆ Are you sure the surviving spouse won’t appreciate cash at death of first spouse?
- ◆ Is it possible that Survivorship Life correctly answers the wrong question?

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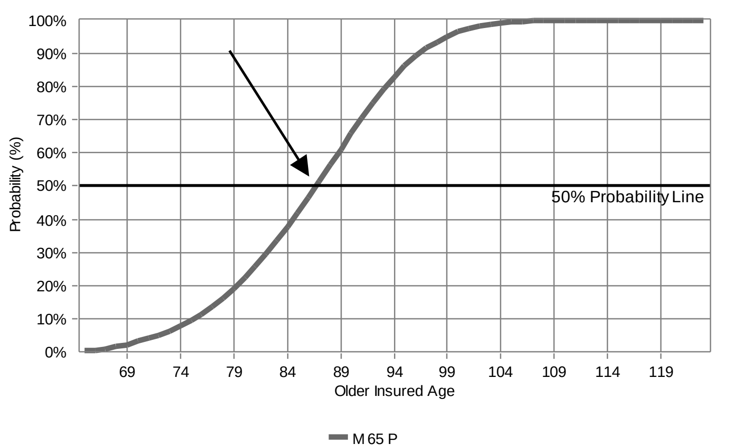
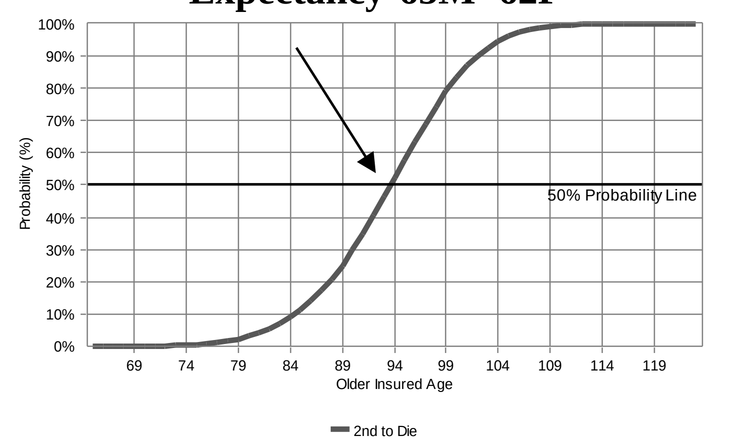
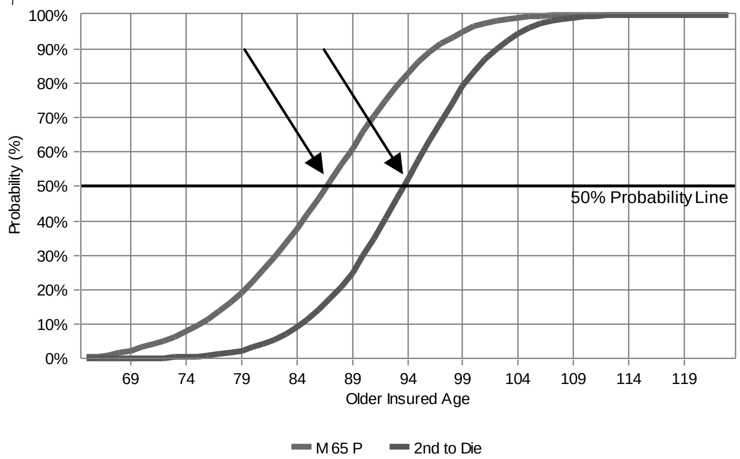
Let’s look at Life Expectancy-65M



Let’s look again at 2nd to Die Life Expectancy-65M+62F



62 Male & Second death LE



Food for thought

- Lack of widow's involvement in original plan
- Continuation of premium required
- Gift capacity cut in half
- Asset depletion
  - ✓ Longevity
  - ✓ High Lifestyle relative to investment returns
  - ✓ Increased cost of living (inflation+++)

Let's look at a few scenarios…

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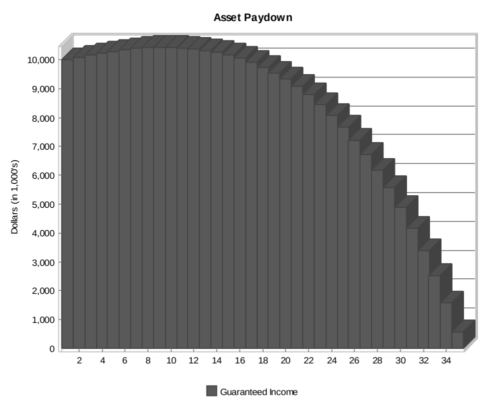
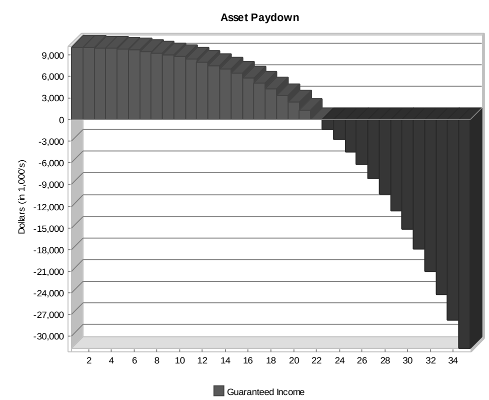
Asset Depletion in Retirement--10M Estate

- 65M+62F
- Initial lifestyle cost: $300,000
- Pre-tax investment return 5%
- 3% cost of living increase
- 30% tax rate



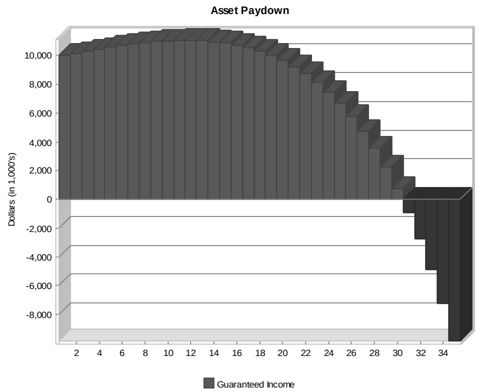
Asset Depletion in Retirement--10M Estate

- 65M+62F
- Initial lifestyle cost: $500,000
- Pre-tax investment return 7%
- 3% cost of living increase
- 30% tax rate



Asset Depletion in Retirement--10M Estate

- ◆ 65M+62F
- ◆ Initial lifestyle cost: $500,000
- ◆ Pre-tax investment return 9%
- ◆ 3% cost of living increase
- ◆ 30% tax rate



Retirement v. Estate Taxation

- ◆ Extended life expectancy will greatly affect estate planning
- ◆ Running out of money is a more realistic fear than the payment of FET
- ◆ Even if money doesn't run out, assets may shrink to well below estate taxable thresholds

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Cash value doesn't matter in an ILIT. I'm just buying death benefit.

- ◆ Reversals of fortune
- ◆ What if you can't pay the premium
- ◆ What if you need the money?
- ◆ What if you don't want the insurance anymore?

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If my life insurance policy hasn't "performed" the smart thing to do is replace it.

- ◆ Look at "fixing" before replacing
- ◆ "Feeding" the existing policy is often a better idea
- ◆ Most new policies will diminish the cash—immediately, and possibly forever
- ◆ Don't analyze on a one-dimensional basis
  - ✓ e.g. only guarantees
  - ✓ e.g. only premium

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A portfolio of “old” “small” policies are a pain, and should be “consolidated” in a new shiny one.

- ◆Run the other way
- ◆Old policies may or not be good
- ◆If they are whole life policies issued by NML, Mass, Guardian they are likely to be the best safe asset you own
- ◆Dividends are the Great Equalizer

IFL data on actual 1985 policy

Lanny Levin 2908748

		1	2	3	4		5
Pol.		Annual	Cumul.	EOY	EOY		Cash on
Year	Cal Yr	Premium	Premium	Cash Val	DeathBen		Cash ROI
							Rate of Retn
25	2008	386	9,650	15,947	35,451		4.90%
26	2009	386	10,036	17,083	36,474		4.59%
27	2010	386	10,422	18,308	37,555		4.80%
28	2011	386	10,808	19,591	38,696		4.80%
29	2012	386	11,194	20,937	39,898		4.81%
30	2013	386	11,580	22,350	41,165		4.82%
31	2014	386	11,966	23,830	42,500		4.81%

IFL data on actual 1975 policy

Lanny Levin 2550018

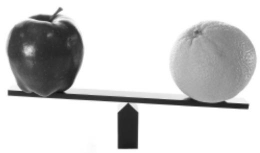
		1	2	3	4		5
Pol.		Annual	Cumul.	EOY	EOY		Cash on
Year	Cal Yr	Premium	Premium	Cash Val	DeathBen		Cash ROI
							Rate of Retn
34	2008	382	12,988	44,448	70,543		5.79%
35	2009	382	13,370	47,324	73,395		5.56%
36	2010	382	13,752	50,444	76,520		5.74%
37	2011	382	14,134	53,729	79,795		5.71%
38	2012	382	14,516	57,192	83,232		5.69%
39	2013	382	14,898	60,844	86,846		5.68%
40	2014	382	15,280	64,693	90,644		5.66%

Selecting a new term insurance policy is as simple as comparing prices.

- ◆Watch the underwriting class!
- ◆Company does count
- ◆How long is it convertible?
- ◆What does it convert to?
- ◆Temporary needs have a way of morphing…

[1]company, conversion product, features

Selecting a new permanent life insurance policy is as simple (?) as comparing two proposals.



- “The illustration is not the policy”
- Watch the underwriting class!
- Company counts more than with term ins.
- Guarantees do count
- Non-guaranteed elements important over time
- Figures lie and liars figure

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A life insurance “illustration” shows how a policy is expected to perform

- “Figures depending on dividends are neither estimated nor guaranteed, but are based on the 2009 dividend scale. “
- “This illustration assumes that the currently illustrated non-guaranteed elements, including dividends will continue unchanged for all years shown. *This is not likely to occur and the actual results may be more or less favorable than those shown.”*
- **Extrapolation versus Expectation**

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Variable UL illustrations exemplify illustration dilemma

Assumed gross earnings:	12.0%	10.0%	8.0%	6.0%
Initial Premium Calc	$2,543	$3,028	$3,870	$5,380
10th yr.Illustrated Acct Val	$15,429	$21,135	$30,501	$4,621
10th yr Actual Acct Val	$11,816	$17,509	$28,732	$46,121
Revised premium	$8,160	$7,759	$6,969	$5,380

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Avoid the “Illustration Beauty Contest”

- Temptation to choose the attractive impossibility vs. the less attractive probability

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So what good are illustrations?

- ◆ Useful to appreciate how the policy type WORKS
- ◆ Can be used to test different assumptions (lower returns, higher/lower premium funding, etc)
- ◆ CanNOT be used to compare one policy to another
- ◆ *Policy types should not be proposed or illustrated until the client's suitability and risk tolerance has been assessed*

Dollar Cost Averaging works just as well on the way out as it does on the the way "in"

- ◆ On the way "in" (accumulation), DCA works fine—a periodic fixed investment buys fewer shares if shares go up, and more shares if shares go down.
- ◆ If the ending value is higher than your average cost per share, you are a winner.
- ◆ On the way "out" (distribution) a large drop in share value, *while you are liquidating a fixed dollar* amount can prematurely bankrupt you.
- ◆ Possible solution: liquidate "units" or %%

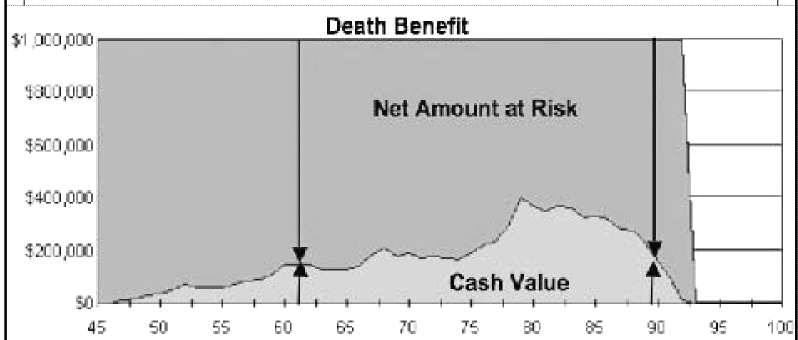
Taking systematic distributions from variable life insurance is just like taking money out of a whole life policy.

- ◆ DCA attractive during accumulation
- ◆ DCA can be disastrous during distribution
- ◆ WL earnings (dividends) may vary, but principal is always guaranteed
- ◆ WL policy distributes "fixed value shares"
- ◆ Variable policy liquidates at fluctuating unit value

The Variable life distribution whipsaw..

- ◆ Variable policy liquidates at fluctuating value
- ◆ Market drop=decrease in policy account value
- ◆ Decrease in policy account=increase in COI
- ◆ Increase in COI=policy account diminished further
- ◆ …and so on and so on…
- ◆ If it occurs early in the distribution timeline, can be disastrous

The Variable life distribution whipsaw..



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Whole Life insurance is archaic, inflexible and expensive.

- “This is not your father’s Whole Life”
- (Ironically) WL *more* flexible than the most popular UL plans (SGUL)
- Blending of “Paid Up Addition Rider” +term insurance increases early value & accomplishes cash flow objective
- It is expensive…like a Porsche or BMW is expensive…higher premium coupled with value does not equal “expensive”

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People who don’t earn an income don’t need to be insured.

- Non-working spouses are extremely under-insured
- Cost of services is high
- Lost income by surviving spouse could be huge
- Life insurance equals flexibility

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Children CERTAINLY don’t need to be insured.

- Correct; they don’t need to be
- You may WANT to purchase life insurance on a child for two primary reasons:
  - ✓Guaranteed insurability ($2 million)
  - ✓Tax-sheltered conservative accumulation

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