How to Make
Permanent Life Insurance
A Good Investment

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Executive Summary

1. Permanent life insurance products are not normally considered a good investment. But it is possible to make them so if certain conditions are met.

2. It is often possible to structure the components of a permanent insurance product to reduce the traditional agent's commissions by approximately 85 percent. This can improve the long-term rate of return of a policy by 1 percent or more.

3. Identifying a company with the lowest possible mortality charges can achieve savings equal to those obtained with low commissions. A recent Society of Actuaries study found that the difference between the best mortality results from one company vs. the mean results for 22 other leading companies improved long-term rates of return by 90 to 140 basis points depending on the age of the insured.

4. A low commission life insurance policy with the most competitive mortality and expense charges offers an attractive investment opportunity in comparison with similar taxable investments. Removing 85% of the commission cost and obtaining top mortality results can improve rates of return by 200 basis points, or 43%, over the returns from an average policy with a standard commission (pages 4-6). With such a policy, even if the dividend interest rate were to decline by 1 percent below the current rate and the insured were to live to age 95, the tax-free rate of return would be 6.5 percent. With combined federal-state tax rates of between 30% and 40%, the taxable equivalent rate of return for this low-risk, fixed income investment would range between 9 and 11 percent.

5. For the very wealthy, domestic private placement and offshore life insurance policies offer broader investment options and the possibility of additional savings on policy expenses in comparison with standard variable life policies using registered securities products. However, one should have investment assets of at least $25 million and be prepared to allocate $5 million to these products in order even to consider them.

6. A fee-only life insurance advisor can provide cost-effective, objective advice whenever a policy's annual premium equals at least $5,000 - $10,000 or when the cash value of an existing policy amounts to at least $50,000 - $100,000.

7. Permanent life insurance deserves serious consideration in a variety of investment, estate, and business planning situations, given the ability of a low-cost, well-performing policy to beat the risk-adjusted returns of comparable investments by significant margins.

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by
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Most professional advisors and personal financial journalists suggest that "permanent" life insurance is a relatively poor investment for those likely to live a normal life span.[1] This generalization is true for most life insurance. But it does not, or need not, apply in all cases. It is possible for life insurance to be a very good investment, even for those who live a long time.

Whether life insurance is a bad, good, or indifferent investment depends on five factors other than, or in addition to, the performance of the underlying investment assets. For the purposes of most of this discussion, we will assume that the nature of the investment – fixed income or equities – remains the same whether it takes the form of a life insurance policy or an alternative vehicle.

The five non-investment factors that determine the rate of return of a life insurance policy (other than longevity) are:

- The level of the sales commissions for the agent or broker, which, as outlined below, can influence the internal rate of return of the policy by 1% or more.
- The cost of the pure insurance coverage itself, sometimes referred to as the mortality and expense charges. Differentials in such costs for policyholders of the same age and health can also alter policy rates of return by 1% or more.
- Whether any of the investment gains within the policy will be taxed at some point. Insurance policies held until death are a tax-exempt investment, since life insurance death benefits are exempt from income taxation in almost all cases. Investment gains withdrawn from a policy during an insured's life in excess of premiums paid are taxed as ordinary income, except when taken out as loans.
- Whether the insurance death benefit in excess of the policy's cash value is deemed to have value by the policyholder. Life insurance is often marketed as an investment to those who, because of their pre-existing financial security, may have little or no interest in the additional death benefit their heirs would receive if they die prematurely.
- The amount of the investment into the policy in relation to the death benefit. The greater the investment in a policy in proportion to the death benefit, the lower are the mortality charges, which comprise the largest portion of the pure insurance cost. That is because the insurance company's exposure at any time – its "amount at risk" - is limited to the

[1] The term "permanent insurance" is used generically here to include whole life and universal life policies, where the investment component of the policy takes the form of the insurance company's fixed-income oriented portfolio, and "variable" life, where the policy owner chooses underlying mutual fund-type investments, most of which include equities.

difference between the current cash value of the policy that the policy owner can claim while living and the death benefit if the insured should die.

Because the level of sales commissions and the mortality costs are the two variables that are most influenced by choice of life insurer, policy, and premium structure, this discussion will focus on those determinants policy rates of return. At the same time, let us first give some passing attention to the other three factors.

Future Income Tax Treatment: To receive tax-exempt treatment of the life insurance investment, the policy owner must keep the policy until death and, during the insured's life, avoid the permanent withdrawal of cash value from the policy, combined with the receipt of policy dividends, in excess of premiums paid. Ordinary income taxes are imposed on amounts permanently taken out that exceed this tax "basis" in the policy.

It is therefore possible to avoid income taxation by limiting withdrawals to basis and by taking any excess in the form of loans, rather than permanent withdrawals. Great care must be taken, however, with regular periodic reviews, to limit the amounts borrowed so that buildup of unpaid loans and accrued loan interest, relative to the cash value in the policy, does not cause the collapse of the policy before the death of the insured. If that should happen, all of the amounts borrowed, and the accrued interest in excess of premiums paid, would be subject to ordinary income taxation.

In any case, life insurance will obviously appear to be a much more attractive investment if it is assumed and expected that none of the investment gains, or the death benefit, will be subject to taxation than if the investment appreciation in excess of basis will be eroded by income taxation at ordinary income tax rates.

The Perceived Value of the Insurance Benefit: Those who are encouraged to invest in life insurance purely for its potential tax benefits noted above may not, if they are already financially secure, accord much value to the additional death benefit if they die prematurely. Clearly, there is an objective value to such coverage and a cost to the insurer in providing it. Even so, if its full value is not appreciated, that will likely influence an analysis of life insurance versus a likely comparable investment.

If the pure life insurance provided through the life insurance investment is needed, or at least valued for what it would cost if term insurance were to provide similar coverage for a period of years, the assumed "cost" of the insurance investment should be reduced by the value of such equivalent term insurance. Otherwise, that cost will be viewed as an added investment expense that reduces the gross return of the insurance investment. In this case, the insurance investment will not look as attractive in comparison with the non-insurance alternative as it would if the value of the pure insurance coverage is assigned a value equal to the cost of comparable term insurance.

The Insurer's Amount at Risk: Where the tax-advantaged investment features of life insurance are more highly valued than the insurance coverage itself, a policy may be structured, within limits, to maximize the premium payments for the amount of death benefit provided. This reduces the exposure of the insurance company in the event of the insured's death since, as explained above, the carrier's amount at risk is limited to the difference between the current cash value of the policy and its death benefit. In "cash-rich" policies, where the investment build-up is high relative to the death benefit, the insurer's amount at risk – and therefore the mortality or pure insurance cost of the policy – is contained.

A series of complex rules limits the investment value of a life insurance policy in relation to the death benefit. In the first place, an excessive concentration of cash in a policy will disqualify the arrangement as life insurance, forfeiting the tax-exempt treatment of the death benefit and the tax-deferred growth of the investments within the policy.

Assuming a heavily funded policy has a sufficient death benefit to qualify as life insurance, paying too much of the premiums in the early years could make the policy a "modified endowment contract (MEC)." In that case, two ancillary tax advantages would be lost. The first is the ability to recover the premium investment in the policy first on a tax-free basis before any further withdrawals trigger ordinary income taxation. The second lost benefit would be the right to borrow cash value from the policy on a tax-free basis.

In all cases, investment-oriented life insurance policies need to avoid such heavy funding that they fail to qualify as life insurance. Whether it is also important to steer clear of modified endowment contract status depends on whether the policy owner or beneficiaries want to retain the flexibility to withdraw the premiums invested in the policy and possibly to borrow additional amounts on a tax-free basis during the insured's life. In most cases, even in the highest net worth situations, it will be desirable to meet the requirements both to qualify as life insurance and to avoid MEC treatment.

Reducing Agents' Commissions: First-year expenses, especially the payment of a standard first-year agent's commission, can detract significantly from the long-term performance of a permanent insurance product. Commissions have by far the largest impact on the short-term performance of an insurance policy, and, under most premium and commission structures, they result in almost no cash value accrual within a policy in the first year or two of a new policy.

The typical first-year agent's commission is largely responsible for this drag on product returns. Including portions of commissions paid to general agents and amounts paid as "expense allowances," commissions can often exceed 100% of the first-year premium. They typically range between 5% and 10% of the premium for the next 5 to 10 years.

While the impact of high commissions on policies that are surrendered in the early years is most severe, even for policies held until death, unnecessarily high commissions can reduce the internal rate of return of a policy by 1% or more.

At one time, inflexible premium structures on whole life insurance policies gave the consumer no choice. This is no longer the case. Today, the agent and policy applicant have considerable discretion in structuring a policy and premium so as to reduce the standard commission by 80% or more. This is done by designing a policy with a maximum amount of term insurance and a minimum amount of permanent insurance and then having most of the annual premium payments take the form of "additional premiums" or "dump-ins" on which the commission may run about 3 percent, or a mere 5 percent of the standard first-year agent's commission.

The difference between the full commission and the low-load commission falls straight to the bottom line, builds immediate cash value within the policy, and substantially enhances long-term returns from the policy.

The ability to achieve these savings and to increase policy values in the process is not limited to special products with very large premiums, such as the private placement and offshore life insurance policies discussed below. Premiums can be structured to eliminate most of the commission for most any permanent insurance policy – whole life, universal life, or variable life – offered by the best companies. The process simply requires objective expertise and oversight over the agent or broker in applying for the policy to be sure that the premium is structured to minimize commissions.

Example of Commission Savings: Consider the example illustrated in the charts on the page attached to this article. It involves a $1 million permanent insurance policy for a 56-year-old male with an annual premium of $36, 685. With a low commission of only $3,950, the death benefit rate of return at age 85 is about 1% (100 basis points), or almost 20% higher, than with a standard commission ($26,260) based on 55% of the first-year premium and an "expense allowance" of 30% of first-year commissions. The low commission is only 15% of the higher commission, a striking example of the ability to reduce commissions on today's flexible insurance policies to enhance returns.

The initial impact of this difference in commissions on policy performance is dramatic. It is revealed by the disparity in first-year cash values between the low commission and standard commission policies - $33,000 vs. $3,000. With the low commission approach, more than 90% of the first-year premium goes to work immediately within the policy to build long-term values. With the standard commission, almost all of the first-year premium is siphoned off to pay the agent's and other commissions (to the general agent, brokerage manager, etc.) and expenses.

The ultimate difference looks at least as startling in dollar terms as it does in percentage terms. With the low commission, the death benefit projected at age 85 increases from $3,626,000 to $4,351,000.

For purchasers of larger policies, in particular, there is no reason to be throwing away this kind of money. Up to this point, the potential to obtain substantial savings from low-load commissions has remained a carefully guarded secret of life insurance companies and agents. It is time to spread the word about this important opportunity. Smart consumers, of the kind who have fueled the growth of the no-load mutual fund industry, can, with the benefit of objective advice, receive much greater value for the premiums they pay.

The Additional Advantage of Low Insurance Charges: If, on top of this differential from commission savings, one gains a further edge by obtaining the policy from a company with the best mortality results, rather than one with average mortality charges, that can produce an additional rate of return advantage of 1 percent or more.

Perhaps the most telling evidence of the extent of rate of return differences as the result of differences in the mortality of the policyholders of different companies comes from a recent private study of mortality results by the Society of Actuaries. It involved a review of the results of 22 leading companies, looking at policies issued over the previous 15 years with deaths occurring in the prior 5 years. It revealed that the impact on the dividend interest rate (roughly equivalent to the impact on rate of return) of differences between the best results from one company and the mean performance of these 22 companies was a full 100 basis points (1 percent) for policies issued at age 45, 140 basis points at age 55, and 90 basis points at age 65.

These differences are so great that they may be hard to believe. Indeed, they suggest that, given the same investment performance and non-mortality expense charges among insurers, differing mortality results between companies are a compelling basis to choose one company over another where the underwriting results make such a choice possible. Low mortality charges for a particular carrier may even make it the company of choice where the underwriting rating it offers is somewhat less favorable than another company's.

Differences in mortality charges between an existing policy and a proposed new one may also make a policy replacement economical. If the health of a client with existing insurance is good, the possible long-term savings may also make it advantageous to replace an existing policy of a company with relatively high mortality charges with one with substantially lower costs.

Combining Low Commissions with Low Mortality Charges: The best rates of return on life insurance investments, regardless of the nature of the underlying investment assets (e.g., fixed income or equities), are experienced when life insurance can be obtained from a company that has enjoyed the best mortality results and the policy is purchased with the lowest possible commission. In the above example showing the additional investment returns resulting from commission savings, if the sample policy were also to offer low mortality charges, as opposed to a policy with a standard commission structure and average mortality charges, the age 85 death benefit rate of return increases by almost 200 basis points – 8.29% vs. 6.34%. This difference

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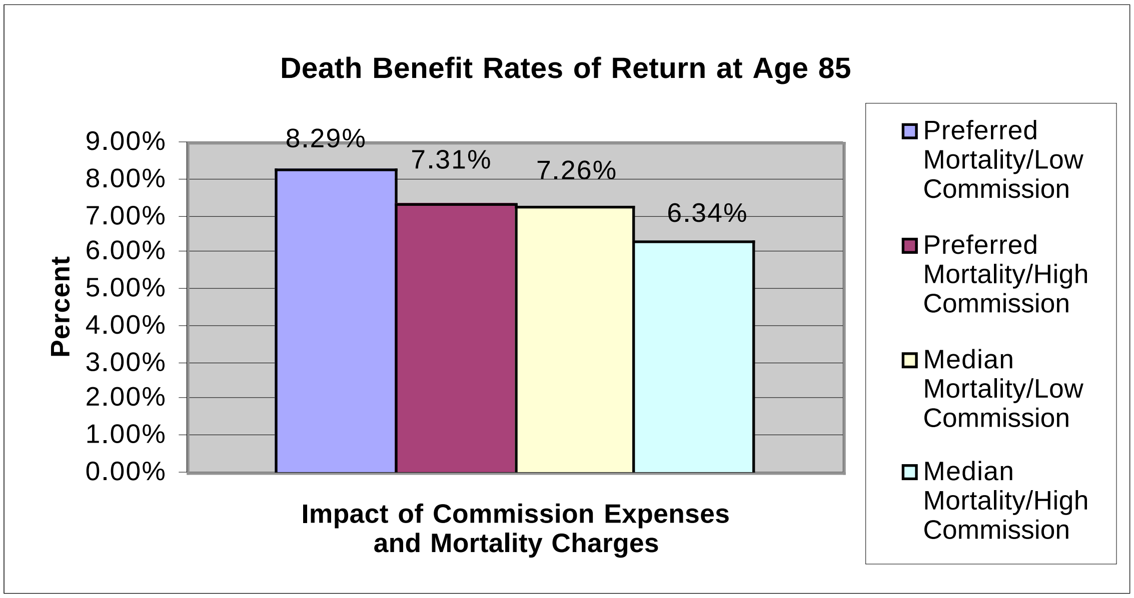
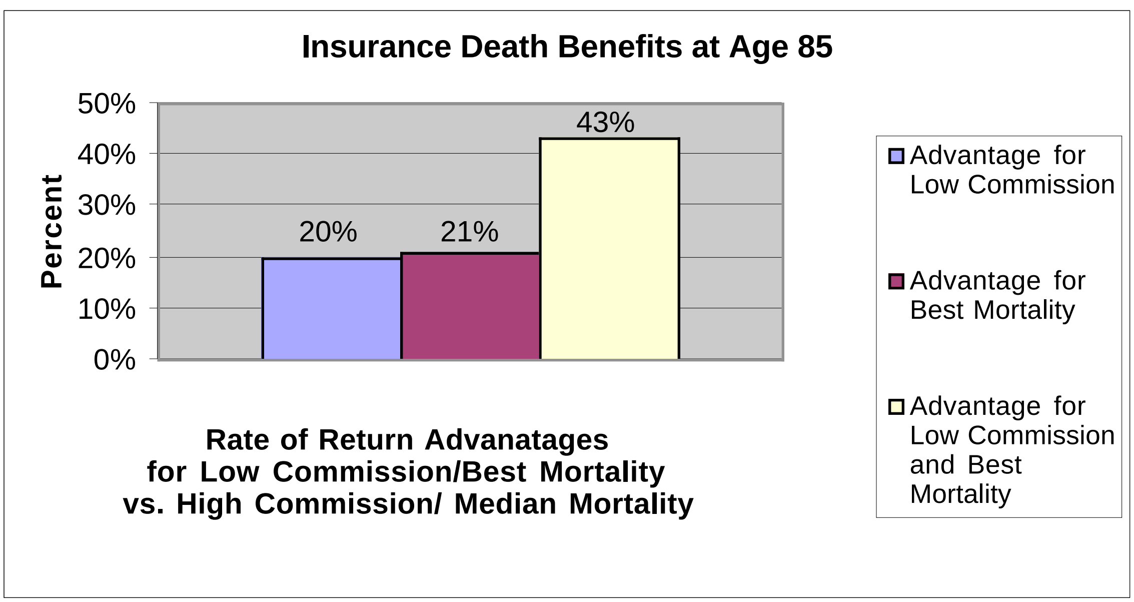
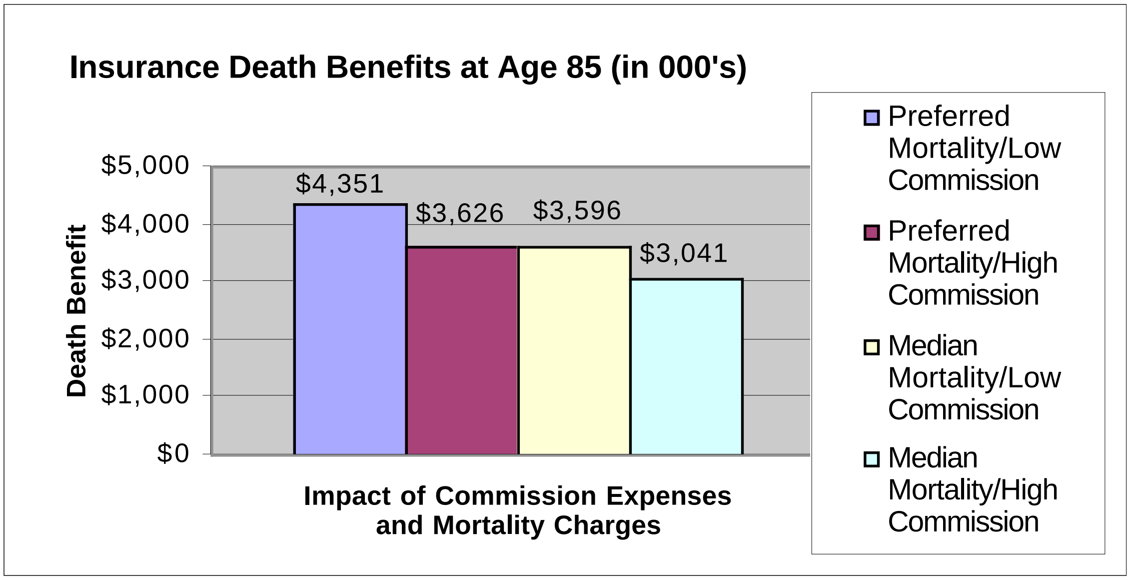
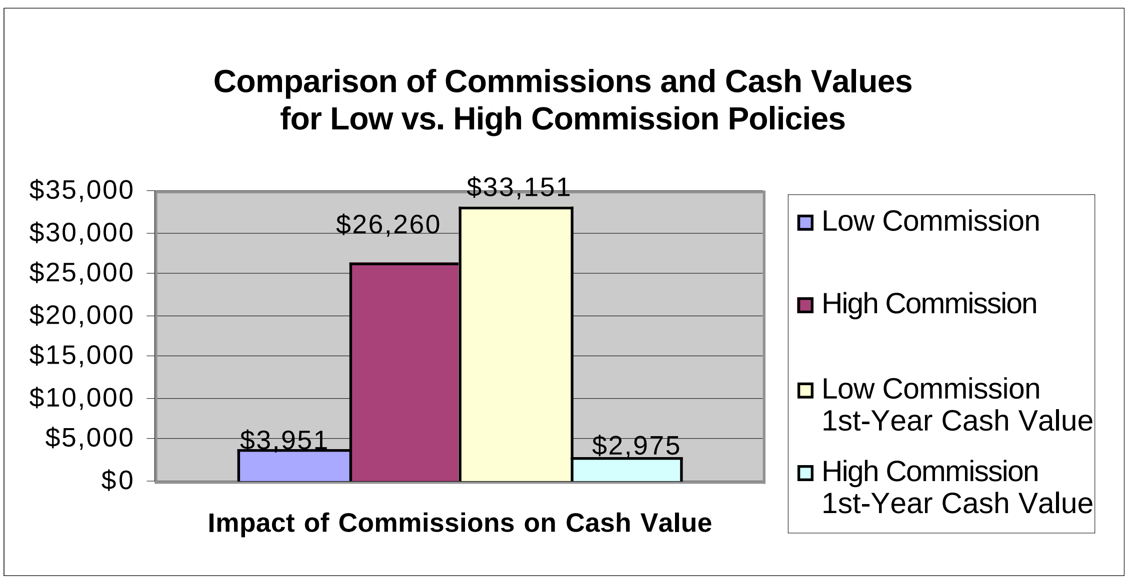
Impact of Commissions and Mortality Charges on Insurance Policy Rates of Return
$1 Million Policy for 56-Year-Old Male with $36,685 Annual Premium









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translates into a death benefit from the low commission/low mortality policy that is 43% higher than that produced with the alternative - $4,351,000 vs. $3,041,000. These dramatic differences are depicted in the charts above.

What about No-Load Life Insurance? So far, we have been taking about the advantages of "low-load" commissions. What about no-load policies? There are a few companies that offer them. If commissions were the sole determinant of comparative rates of return, then the few no-load life insurance products available today would offer a compelling alternative. Yet, thus far, the failure of the no-load companies to achieve top mortality results and to reduce non-commission expenses to the most competitive levels appears to keep them from offering the most competitive long-term returns in spite of the absence of commissions. In addition, it is often possible today, as in the above example, to reduce the standard commission to such an extent that it barely detracts from a policy's long-term rate of return. Looking for a company that excels in limiting mortality and non-commission expense charges and then reducing commissions in the manner suggested above can provide the best returns. As products and companies change in the future, the possibility that the no-load alternative might become more competitive in these basic ways will bear watching. For now, it does not appear to offer an advantage.

Insurance as an Investment with a Low Expense Product: The implication of the preceding discussion about the favorable impact of low commissions and low mortality charges is that life insurance, under these circumstances, emerges as a most competitive investment. That is especially true where (1) the policies are held until death so that insurance proceeds are received free of income taxes, or policy values are otherwise withdrawn or borrowed during life without tax consequence; and (2) the comparative after-tax or tax-free returns are compared to investments with similar risk characteristics.

In fact, if, as noted above, it is possible to add 200 basis points or more to the returns of the standard life insurance policy by taking out most of the commission cost and obtaining the benefit of low mortality and expense charges, the tax-free returns of a life insurance policy can look very attractive compared to similar investments. If, for example, one considers the possible returns from the most competitive whole life policy in the context of other fixed income investments, a tax-free yield of 6.5%, or more, should have great appeal compared either to tax-free municipal bonds or taxable corporate, U.S. Treasury or other government issues.

To test this thesis, consider the best performing policy (as the result of a low commission and low mortality charges) from the charts on the previous page and assume that the 8.29% death benefit rate of return at age 85 declines because the assumed dividend interest rate on the illustrated falls by 100 basis points and higher mortality costs are incurred because the insured lives to age 95 rather than 85. Even in that situation, the projected death benefit rate of return is 6.5 percent. That tax-free return is equivalent to an after-tax return from a taxable investment of 9.3%, assuming a combined 30% tax rate, 10% with a 35% tax rate, and 10.8% with a 40% tax rate. These are clearly most impressive returns for a low-risk, fixed income investment. The comparisons could be equally or more compelling when considering the possible investments available through a range of variable life products.

Life Insurance Investments with Private Placement or Offshore Life Insurance: Up to this point, we have considered ways to make life insurance a more efficient, tax-favored investment vehicle without regard to the nature of the underlying investment assets. We have assumed the use either of an insurer's traditional fixed income-oriented "regular portfolio" product or the variable life alternatives with a set menu of underlying mutual funds.

For very wealthy investors, however, private placement and offshore life insurance present additional options that combine the ability to reduce the costs associated with life insurance and to seek more aggressive or specialized investment alternatives than the choices normally available within a conventional variable policy.

It is first important to understand that either private placement or offshore life requires very substantial minimum investments – annual premiums of $250,000 and a total premium commitment of $5-$10 million in most cases. Consequently, investors should have at least $25 million in investment assets before considering either of these more exotic life insurance alternatives.

A detailed discussion of private placement and offshore life insurance is beyond the scope of this review. Included here is a brief overview of the cost and investment factors that may cause the highly affluent to investigate these products.

Cost Advantages: The cost advantages of these specialized products relate to potential savings on sales commissions, on internal policy "mortality and expense risk" charges imposed within variable life policies, and, in the case of offshore life insurance, on state premium taxes.

Commissions are negotiable with either private placement or offshore insurance. They may amount to 1% or 2% of premium payments, or they may be avoided altogether in favor of fees paid to advisors who help to structure the transaction. We have already explained how it is possible to enhance policy rates of return through commission savings on the best retail life insurance policies by 100 basis points or more. Additional commission savings through these specialized products might add another 10-15 basis points, but probably not any more than that.

"Mortality and expense risk" or "m & e" charges generally constitute the insurer's source of profit, assuming the price of providing the pure insurance coverage is based on its cost. With a retail variable life policy, these "m & e" charges are set as a fixed percentage of the cash value, generally between .5% and 1%. With private placement and offshore insurance, the percentage charges will be much lower, reflecting the large balances on which they are imposed.

State premium taxes vary considerably from state to state, from over 2% in many states to an almost negligible amount in Alaska. For those who lack a practical means of minimizing state premium taxes, an offshore life insurance policy presents a way to avoid them altogether. These policies also escape the impact of the federal income tax treatment of "deferred acquisition costs" in life insurance policies. However, a 1% federal excise tax on premium payments by U.S. residents to foreign-based insurers largely offsets this potential savings.

Additional Investment Options: The chief attraction of private placement and offshore life insurance products is the broader array of specialized investment options made possible by the more lax regulation of these products. Domestic variable life policies may only offer securities products registered with the Securities and Exchange Commissions. Consequently, the policy investment choices represent a range of fairly standard mutual funds managed either by the insurance company or, more often, by independent name-brand money managers. Private placement and offshore policies most often feature "unregistered" securities that can only be sold to high net worth investors.

The investment alternative of choice is often hedge funds, which are unregistered investment partnerships. Because of the high volume of short-term trading with most hedge funds, they generate substantial amounts of ordinary income when held in a taxable account. Inside of a life insurance policy, these gains are tax-deferred at least. Since these policies are generally held until death, and withdrawals from them are limited to those with are tax-free, these investment gains usually escape taxation altogether.

The investment choices, including hedge fund alternatives, may be somewhat broader through certain offshore policies than with the domestic private placement policies. In either case, however, the investment, in order to qualify as life insurance under federal income tax law, must satisfy certain diversification requirements and avoid "investor control." The investor can propose a certain investment alternative, such as a hedge fund manager, to the insurer. But the insurer must control the decision of the individual policy investment "sub-accounts" that it will offer in the policy.

Balancing Objectives, Costs, and Risks: Whether those who are in a financial position to consider domestic private placement or offshore life insurance ultimately pursue it will depend on whether the perceived investment, and possible cost-savings, opportunities outweigh the increased investment and regulatory risks.

The private placement and offshore alternatives will hold the greatest appeal to those seeking life insurance investment alternatives unavailable among registered domestic products. Given the commission savings generally available through carefully designed and monitored premium structures on standard policies, the case for these alternative policies is simply not as great where the underlying investments would be substantially similar within any of the policies. However, one would want to examine the magnitude of any additional savings on commissions and lower "m & e" charges available through the domestic private placement or offshore policies.

In addition, any analysis should compare the pure cost of insurance in the alternative products. It is likely to be lower through domestic companies with the best histories of controlling these costs than with the relatively few companies serving the private placement and offshore markets. Because these investment-oriented policies minimize the death benefit relative to the cash value as much as possible, however, the insurer's exposure – the "net amount at risk" against which insurance costs are calculated – is limited. In that case, relatively modest differences in insurance costs may not be a significant factor.

In the offshore market especially, a careful review of the insurer's (and the reinsurers') financial strength is required. While the financial trouble of the carrier would not threaten the separate investment account of a variable policy, it could jeopardize the insurer's ability to pay a large death benefit in the distant future. For that reason, in the offshore market, it may seem wise to place any coverage with the foreign subsidiary of a solid U.S. life insurer.

The issues and choices are complex, and the stakes are high. Such is the price associated with the proliferation of life insurance investment options for the very wealthy. Those in a position to consider the additional alternatives available through the domestic private placement or offshore private placement markets should not quickly conclude that either offers an advantage over the other or, necessarily, over the best standard domestic product with reduced commission costs. Once again, the choice will depend on investment objectives, potential additional cost savings, and the risks, real or perceived, in attempting to pursue them.

The Role of a Fee-Only Life Insurance Advisor: In cases involving larger purchases of life insurance ($5,000 of annual premium or above), a fee-only life insurance advisor will best assure the most competitive risk-adjusted returns from a life insurance investment. When dealing directly with an agent or broker, it is difficult to imagine that one could know the extent to which commissions are reduced, if at all. Company and product choice is limited to those which the agent or broker happens to sell. The fee-only advisor can work with an agent and broker to choose one or more insurers likely to offer the lowest insurance costs and most competitive investment returns and to arrange a premium structure that can shave 80% or more off a typical policy commission. The agent will be adequately compensated, considering that the transaction will not involve the kind of sales activities that consume the vast majority of an agent's time. The commission dollars saved will stay in the policy and add substantially to its long-term rate of return.

The cost of fee-only insurance advice will prove a small fraction of the savings achieved over conventional approaches to buying life insurance. Perhaps as importantly, the consumer is assured that the advice is untainted by any compensation from the sale of a product. In the market for life insurance, or personal financial services generally, unquestioned objectivity is a rare and valuable commodity.

Implications of Life Insurance as a Good Investment: An unnecessarily high cost structure has made life insurance the Rodney Dangerfield of investment products. It has received little respect, and, for the most part, deservedly so. Reduce sales commissions dramatically and choose a company and policy with historically low mortality and expense levels, however, and an investment that would register mediocre investment performance or worse can suddenly beat the after-tax, risk-adjusted returns of comparable investments by a significant margin (as explained on page 9 above) – by 150 to 300 basis points, for example, for a regular portfolio fixed income-oriented life insurance policy in comparison with a similar investment portfolio without the tax advantages of life insurance. These investment results come with a price of some inflexibility, since the life insurance policy should be held until death, or withdrawals should at least be limited to those which can be taken on a tax-free basis in order to achieve the best results.

In any case, the ability of life insurance to produce such impressive investment returns has a number of implications. The best products deserve serious consideration as a piece of an investment portfolio for those who are already making maximum contributions to qualified retirement plans and have additional cash to invest. There will also be more estate and business planning situations – e.g., inter-generational wealth transfers, funding of buy-sell and deferred compensation plans - where high-grade permanent life insurance will look like a much more compelling alternative than it has in the past. The existing market for the best permanent life insurance will and should expand considerably when consumers and their advisors recognize what a good investment it can be in a variety of situations.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.